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TAX INCENTIVES TO INCREASE ENERGY SECURITY

HEARING

BEFORE THE

SUBCOMMITTEE ON
ENERGY AND AGRICULTURAL TAXATION

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

S. 200, S. 233, and S. 846

JUNE 5, 1987

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TAX INCENTIVES TO INCREASE ENERGY SECURITY

FRIDAY, JUNE 5, 1987

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:12 a.m. in Room SD-215, Dirksen Senate Office Building, the Honorable David L. Boren [chairman] presiding.

Present: Senators Boren, Bentsen, Matsunaga, and Daschle.

[The press release announcing the hearing and the prepared written statement of Senators Boren, Bentsen, and Wallop follows:]

[Press release]

FINANCE SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION ANNOUNCES HEARING ON TAX INCENTIVES TO INCREASE ENERGY SECURITY

Washington, DC.—Senator Lloyd Bentsen (D., Texas), Chairman of the Committee on Finance, announced today that he has asked Senator David Boren (D., Oklahoma), Chairman of the Subcommittee on Energy and Agricultural Taxation, to hold a hearing on proposals to repeal the windfall profit tax and to increase U.S. oil reserves.

The hearing will begin at 10:00 a.m. on Friday, June 5, 1987 in Room SD-215 of the Dirksen Senate Office Building.

"Our nation is much too dependent on imported sources of oil and gas. I have asked Senator Boren to hold this hearing so that we may examine methods of addressing this problem through narrowly targeted tax incentives," Senator Bentsen said.

"This hearing will give us an opportunity to focus on the risks of increasing import dependency, and to evaluate the merits of various proposals that have been put forth. I am confident that this hearing will lead to a more informed decision regarding the energy security of the United States."

"America's dependence on foreign produced oil has risen dramatically over the past 18 months," said Senator Boren. "At the same time, our domestic industry has been devastated by artificially low prices.

"The United States has a clear strategic interest in ensuring that we have the ability to produce the energy we need. We must act on a comprehensive energy policy now that maintains our production capabilities. The hearing we have scheduled will focus on methods to ensure energy independence through narrow changes in the tax code."

The witnesses will be asked to comment on the following specific issues: (i) whether the windfall profit tax should be repealed, (ii) whether it is appropriate to enact tax incentives designed to stimulate exploration activity and increase United States oil reserves, and (iii) if tax incentives are appropriate, what types of tax incentives should be enacted. The hearing will focus on tax incentives proposed by the administration, by Congressional sponsors (e.g. S. 233 and S. 200), and by industry groups.

The Subcommittee on Agriculture and Energy Taxation
Finance Committee

Oklahoma Senator David L. Boren, Chairman

Hearing on Proposed Tax Code Changes
Involving the Energy Industry
Friday, June 5, 1987
10 am, Dirksen 215

Opening Statement by the Chairman

Ladies and gentlemen we are here today to discuss in some detail the repeal of the so-called "Windfall Profit Tax", removal of other dis-incentives to domestic production found in the Tax Code, and finally to analyze limited tax credits to encourage domestic drilling and the replacement of oil and gas reserves.

Briefly let me set the stage for today's hearing. In 1981 there were over 4,700 drilling rigs looking for additional oil and gas reserves in the United States. Today there are less than 760 rigs operating. In 1981 we were importing only 20% of our energy needs from foreign sources. Today that number has doubled to over 40%. Our consumption has increased over 500,000 barrels per day in less than 18 months and yet our domestic production has decreased over 800,000 barrels per day during the same period. That is a net loss of 1.3 million barrels per day! When this is added to the fact that 80% of the oil service industry has been dismantled and over 120 refineries have shut their doors it should be obvious to even the most casual of observers that something must be done to stop the hemorrhaging of this vital industry.

The so-called Windfall Profit Tax which is plain and simple an excise tax on the production of crude oil has drained over $77 billion away from our domestic energy industry in just 5 1/2 years. The tax has in fact failed to raise any revenue since the second quarter of 1986. Under current law this excise tax will begin to phase out in January, 1991. However, under a "higher" price scenario envisioned by the Department of Energy in their Energy Security Report to the President, this tax will fail to raise one penny in revenue from newly discovered oil by 1991.

While the federal government has not raised one penny of revenue during the past 12 months, not only have small independent producers in Oklahoma incurred substantial recordkeeping costs but the Treasury Department's Internal Revenue Service has no doubt incurred millions of dollars of expenses in keeping track of all of this superfluous paperwork. It is high time that we repeal this onerous and destructive tax.

It is my objective today to take this discussion of our domestic energy industry beyond the obvious action of repeal of the so-called Windfall Profit Tax to the not so obvious need for renewed incentives to replace our dwindling reserve base.

We will hear testimony today urging a small tax credit for a broad range of drilling expenses. The Joint Tax Committee has analyzed a 50% credit for wildcat drilling only. The fact remains that domestic drilling has been reduced by at least 80% over the past several years. Unless we maintain minimal amount of activity during these difficult times, we run the risk of becoming subject to the economic whims of Third World leaders.

Finally we will hear testimony advocating the removal from the Tax Code of various small disincentives to the continued production of marginal properties. Such items include the repeal of the proven property transfer rule, repeal of the 50% net income and 65% taxable income limitations for percentage depletion deductions. These are measures that currently work a hardship on small independent producers as they struggle to maintain the production of the hundreds of thousands of stripper wells located in 29 states across our nation.

The time has come to take action. We won't be able to solve all of our problems with the proposals before us today. However, the action that results from this hearing will begin to lay a foundation upon which we can base our long term energy plans.

Hearings of
The Subcommittee on Energy and Agriculture Taxation
Oklahoma Senator David Boren, Chairman

June 5, 1987

Proposals Introduced by Senator Boren
Under Consideration Today

S. 233 Introduced January 6, 1987

Various Energy Tax Changes Included:

*REPEAL OF THE PROVEN PROPERTY TRANSFER RULE: Current law provides that when an independent producer buys "proven" producing property from an integrated major, that property is not eligible for Windfall Profit Tax exemption or percentage depletion. Repeal of the transfer rule would allow independents to benefit from percentage depletion and any Windfall Profits Tax exemption that may exist. This would benefit both the integrated companies by encouraging them to sell uneconomic properties, rather than abandoning them, and provide additional incentive to independents to purchase and continue to produce these properties.

*REPEAL OF THE 50% OF NET INCOME LIMITATION: Current law provides that the percentage depletion deduction is limited to not more than 50% of the net income of an eligible producing property. Repeal of this section would stimulate additional cash flow to those producers who still have income producing properties.

[Continued]

*PERMIT EXPENSING OF GEOLOGICAL AND GEOPHYSICAL COSTS: These costs of searching and testing for oil are capitalized under present law. However, they are ordinary and necessary costs of doing business which should be deducted when incurred. If these costs were deductible, the cost of exporation would be reduced.

Note: S. 233 Contains other provisions which will not be considered today.

S. 255 Introduced January 6, 1987

Repeal of the Windfall Profits Tax

REPEAL OF WPT REPORTING REQUIREMENTS

Millions of forms 6248 are filed each year by oil purchasers, operators and producers showing information on the Windfall Profit Tax. In 1986, there were "windfall losses" for most of the year except for a small amount of Tier 3, newly discovered oil in the first quarter.

Therefore, hundreds of thousands of these forms 6248, those without any first quarter Tier 3 production, will be filed with no useful information.

The maximum [redacted] penalty for failure to file these forms is [redacted] $100,000.

The Internal Revenue Service could, through issuance of an information release state that form 6248 is not required to be filed where the information to be included in the form serves no purpose (e.g. where no WPT is present).

[redacted]

ASAMERA OIL (U.S.) INC.
POST OFFICE BOX 118
DENVER COLORADO 80201

069881

PARTNERSHIP PROPERTIES
P O BOX 85224
DALLAS TX 75285

DEAR REVENUE PARTICIPANT:

ENCLOSED IS FORM 6248 ALONG WITH A SUMMARY OF BARRELS, REMOVAL VALUE, ADJUSTED BASE PRICE, AND WHERE APPLICABLE, WINDFALL PROFIT TAX WITHHELD BY ASAMERA OIL (U.S.) INC. FOR OIL REMOVED IN 1986. THE I.R.S REQUIRES THAT WE FURNISH ALL OF THE ENCLOSED INFORMATION EVEN IF YOUR 6248 SHOWS NO TAX LIABILITY.

IF YOU NEED ASSISTANCE IN PROPERLY TRANSFERRING THE ENCLOSED INFORMATION TO YOUR TAX RETURN, WE URGE YOU TO CONTACT YOUR TAX ADVISOR.

IT HAS BEEN OUR PLEASURE SERVING YOU IN 1986.

YOURS TRULY,

ASAMERA OIL (U.S.) INC.

Form **6248**
Department of the Treasury
Internal Revenue Service

Annual Information Return of Windfall Profit Tax—1986

OMB No 1545-0224
Copy C—File with the Producer or Other Recipient

Producer or Other Recipient 569841

Name, address, and ZIP code

PARTNERSHIP PROPERTIES
P O BOX 45224
DALLAS TX 75245

Employer identification no. (EIN): 7 5 6 2 0 7 5 1 7

Social security no., if no EIN:

Filer

Name, address, and ZIP code

ASAMERA OIL (U.S.) INC
P.O. BOX 118
DENVER COLORADO 80201

Employer identification no. (EIN): 8 4 0 2 3 9 6 0 2

Social security no., if no EIN:

If you have received a Form 6248 from another person concerning oil reported on this Form 6248, enter the name and employer identification number of that person below.

Name:

Employer identification number:

Type of return (Check only one box): Original 1 ☒ Corrected 2 ☐ Suspense 3 ☐ Corrected suspense 4 ☐

For IRS use ☐ ☐

Part I Producer or Other Recipient

1 Type of Producer (check all applicable boxes)

Individual 1 ☐ Partnership 2 ☐ Trust 3 ☐ Estate 4 ☐ Corporation 5 ☒ Resident of U S Possessions 6 ☐ U S citizen or entity, or resident alien 7 ☐ Foreign citizen or entity, or non-resident alien 8 ☐

2 Producer Status (check all applicable boxes)

Independent producer 1 ☐ Integrated oil company 2 ☐ Member of related group 3 ☐ Producer - no withholding 4 ☐ Royalty owner 5 ☒ Working interest 6 ☐ Trust beneficary 7 ☐ Operator 8 ☐

Part II Exempt Oil

		a. Tier one	b. Tier two	c. Tier three (1) Newly discovered	(2) Incremental tertiary	(3) Heavy
1 Number of barrels of exempt oil (do not include exempt stripper well oil or exempt royalty owner oil)	1					

2 Total (add amounts on line 1, columns a through c(3)) . . . 2

3 Type of exempt oil (check applicable boxes) Governmental interests 1 ☐ Exempt Indian oil 2 ☐ Charitable interests 3 ☐ Exempt Alaskan oil 4 ☐

4 Total barrels of exempt stripper well oil (see instructions) . . . 4

Part III Exempt Royalty Owner Oil

Total number of certified barrels		a. 1st quarter	b. 2nd quarter	c. 3rd quarter	d. 4th quarter
1 Barrels removed in calendar quarter	1				

2 Total (add amounts on line 1, columns a through d) . . . 2

Part IV Taxable Crude Oil Removed During 1986

		a. Number of barrels	b. Tax liability
1 Tier one, other than Sadlerochit oil, taxed at 70%	1		
2 Tier one, other than Sadlerochit oil, taxed at 50%	2		
3 Tier one Sadlerochit oil taxed at 70%	3		
4 Tier one Sadlerochit oil taxed at 50%	4		
5 Tier two oil taxed at 60%	5		
6 Tier two oil taxed at 30%	6		
7 Newly discovered oil	7		
8 Incremental tertiary oil	8		
9 Heavy oil	9		
10 Total barrels of oil (add amounts in column a)	10		▨

11 Amount of windfall profit tax liability for oil removed during 1986 (add amounts in column b)	11	
12 Amount of windfall profit tax withheld with respect to oil removed during 1986	12	
13 If line 11 is greater than line 12, subtract line 12 from line 11. This is underwithheld windfall profit tax	13	- 0 -
14 If line 12 is greater than line 11, subtract line 11 from line 12. This is overwithheld windfall profit tax	14	- 0 -

Part V Amount of Windfall Profit Tax Withheld from Payments Made in 1986

1 Windfall profit tax withheld from payments made in 1986 (regardless of when windfall profit tax liability arose)	1	1

For Paperwork Reduction Act Notice, see the instructions on back of Copy A.

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WDR6248                              ASAMERA OIL (U.S.) INC.                                   DATE -  1/23/87
TIME  15:27:38               WINDFALL PROFIT TAX FORM 6248 ATTACHMENT                         PAGE -        1

**********  PRODUCER - 069881 PARTNERSHIP PROPERTIES
       * * * * * * L E A S E * * * * * *   TAX    PROD   NUMBER OF     EXEMPT      AGGREGATE       AGGREGATE   AGGREGATE       TAX
TIER   NUMBER            NAME              CLASS  DATE    BARRELS      BARRELS   REMOVAL VALUE      ADJ BASE   SEV TAX ADJ   WITHHELD

                    TOTAL TAX CLASS WPNI     -                  .00         .00            .00           .00          .00          .00

  WPT LIABILITY FOR OIL REMOVED DURING 1986 -                   .00         .00            .00           .00          .00          .00
```

STATEMENT OF HONORABLE LLOYD BENTSEN

FOR HEARING BEFORE
THE SUBCOMITTEE ON ENERGY AND AGRICULTURAL TAXATION
JUNE 5, 1987

Mr. Chairman, this is a timely and important hearing. Our country is being lured down the path toward another energy crisis. Look at the facts:

Production of crude oil in the U.S. fell by 830,000 barrels per day last year. The number of active rigs has also decreased substantially -- from a peak of 4900 in 1981, to an average of 2000 in 1985, down to just over 740 in May, 1987.

Our exploration activity has also declined dramatically. High cost exploration offshore is almost negligible, and idle offshore rigs are lined up like ghostly sentinels along our shores. In 1985 we averaged 378 seismic exploration crews in the field per month. Only 151 crews were employed in February, 1987. This of course has resulted in a tragic loss of employment in these industries. We lost 150,000 jobs last year in the oil and gas industry. The unemployment rate among geologists as of May, 1987 is 35% -- this rate matches levels last seen during the Great Depression.

And yet our nation's thirst for oil and gas has not been slaked by our country's diminished capacity to produce oil and gas. Instead, demand for oil and gas in this country has actually increased by 1.4 million barrels per day.

And where are these additional barrels of oil coming from? Our statistics indicate that most of it comes from the Middle East, one of the most politically sensitive areas in the world. The very fact that we have several warships in the Persian Gulf, and the tragic loss of so many of our servicemen in that region recently demonstrates that we cannot rely on excess production capacity from that part of the world. Our dependence on foreign oil reached about 40% this winter. Unless we act quickly to address this imbalance, our country cannot hope to be able to protect itself adequately.

I look forward to hearing today what the experts think we can do to turn the situation around. I know one thing we can do, and that's repeal the windfall profit tax. If this excise tax ever had any merit, it no longer does today. We face an entirely different oil and gas world today than when the tax was enacted. There are no "windfall" profits today.

The windfall profit tax is no longer generating significant revenue for our government. Yet taxpayers must continue to file complex and burdensome forms with the government. And the IRS must continue to administer the tax. I hope our witnesses can shed some light on these costs.

I also think we need to look at what sorts of incentives might help the country's oil reserves. There have been a variety of proposals: we've had bills introduced; we've had the DOE report; we've had limited recommendations of the President. My colleagues, Senators Dole and Boren, and I asked the Finance Committee and Joint Tax Committee staffs to draw up and analyze a package of proposals. They have done that, and I'm sure most of you have seen the Joint Tax Committee's report.

But we very much need this hearing so that we can try to sort out where we are -- which proposals could have an effect, which would be wasted, which would be efficient, which would be inefficient. That's what I hope to hear from the witnesses today.

STATEMENT OF SENATOR MALCOLM WALLOP

UNITED STATES SENATE COMMITTEE ON FINANCE

SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

JUNE 5, 1987

I thank the Chairman for holding this hearing on an issue that is absolutely vital to my state of Wyoming. The decline in the domestic petroleum industry has devastated Wyoming's economy. High unemployment, increased bankruptcy rates, bank closings, and declining state revenues are but a few of the problems caused by the the depressed petroleum industry. I thank Mr. Richard Robitaille, Executive Director of the Petroleum Association of Wyoming, for being here today to offer testimony on the status of Wyoming's petroleum industry and to offer his insights on what we must do alleviate the situation.

The state of the petroleum industry has not only affected the economy of Wyoming and other oil producing states but is jeopardizing the nation as well. Decreasing domestic production jeopardizes our national security by increasing our reliance on foreign sources of supply. This makes us vulnerable to supply interruptions and to cartel dictated prices.

Mr. Chairman, I am pleased to be a cosponsor of several pieces of legislation designed to revitalilze the petroleum industry. An important part of this legislation is the repeal of the Windfall Profit Tax.

The repeal of the Windfall Profit Tax is necessary for two reasons. First, the decline in oil prices have made provisions of the tax inoperable. Currently, no taxes are being collected.

However, compliance requirements of the law are still in effect. Companies must file millions of meaningless documents with the IRS. These compliance requirements alone cost the industry untold time and money. Time and money that could be used for productive purposes.

Secondly, figures provided by the Joint Committee on Taxation state that the Windfall Profit Tax drained some $79 billion from the industry from its enactment in 1980 through September 1986. This was money the industry could have used for exploring for new supplies. We can ill afford to drain capital from the industry should oil price increases trigger a return to the provisions of this tax. Repeal of the Windfall Profit Tax is a critical step to revitalize the industry.

Mr. Chairman, we must do more than just repeal the Windfall Profit Tax. Passage of other legislation pending before this committee is important. In part, these other measures:

o Allow the expensing of geological, geophysical and surface casing rather than recovery of these costs through depletion provisions.

o Exclude intangible drilling costs from inclusion in alternative minimum tax calculations as a tax preference item.

o Repeal transfer rules for percentage depletion. This provision should encourage integrated producers to sell marginal properties rather than forcing abandonment of the properties which results in an unnecessary decline in reserves.

Mr. Chairman, the condition of our nation's petroleum industry requires our immediate attention. I urge my colleagues to stand behind the legislation now pending before the Finance Committee so that we may begin to revitalize this crucial industry.

Senator **Boren**. The hearing will come to order. We are having hearings this morning, of course, on several proposals that would aid in the domestic production of energy, particularly oil and gas.

It is a privilege to have with us this morning the Chairman of the Senate Finance Committee, Senator Bentsen, and I would like to turn to him first to make an opening statement. Senator Bentsen, we are glad that you joined us this morning.

The **Chairman**. Thank you very much, Senator Boren.

Mr. Chairman, I think these are very timely hearings and I congratulate you on holding them. There is no question in my mind this country is headed towards another energy crisis. It is just a question of how much time will elapse before we have long lines at the gas pumps again.

We have seen a drop in production in this country last year of some 830,000 barrels a day. We have seen the number of rigs dramatically dropped from a peak of about 4,500 rigs in 1981 to about 740 rigs operating in May of this year. Yet our country's thirst for oil and gas has not abated a bit. Instead, we have seen a very substantial increase in the utilization of oil in this country, an increase of about 1.4 million barrels a day.

Our exploration activity has also declined dramatically. High cost exploration offshore is almost negligible, and idle offshore rigs are lined up along our shores. In 1985 we averaged 378 seismic exploration crews in the field per month. Only 151 crews were employed in February, 1987. This of course has resulted in a tragic loss of employment in these industries. We lost 150,000 jobs last year in the oil and gas industry. The unemployment rate among geologists as of May, 1987 is 35%—this rate matches levels last seen during the Great Depression.

There is a lack of understanding of what is happening to the oil and gas reserves of our country. I hear people say to me: Well, all you have to do with those stripper wells is go back there and turn them on again when you need them. That just is not the way it is. Once you have closed down those stripper wells they are generally lost forever.

We are looking at a situation where we are becoming more and more dependent on the Middle East for oil. That has been dramatized in the last few days by the attack on the U.S.S. *Stark* and the loss of U.S. servicemen.

Our dependence on foreign oil in this country got as high as 40 percent in some of the months of last winter. We ought to have learned from what happened to us in 1973 and 1974.

I am looking forward to hearing what some of these experts have to say: What they think we can do to turn that dependence around. One thing obviously has to be done; we must repeal the windfall profits tax. There just aren't any "windfall" profits left in the oil and gas business.

We face an entirely different world in the oil and gas industry today than we did when the windfall profits tax was enacted. And yet taxpayers must go to incredible expense and accounting to try to send the information in to the government. In turn, the IRS must spend its time and resources to audit and monitor all that paperwork.

Senator Boren, Senator Dole and I have asked the staffs of the Joint Tax Committee and the Finance Committee to look at other means of developing incentives for exploration within this country.

The Administration made some proposals but they were moderate indeed. Obviously, they did not go far enough in achieving what has to be done to turn this dependence on foreign oil around.

We have contacted a number of people in the industry showing them what the Joint Tax Committee and Finance Committee staffs developed in the way of possible tax incentives. We want to know those that are efficient and those that are not; those that would actually increase the reserves of our country, and what the cost of it might be. I would be interested to hear what ideas our witnesses have regarding these options.

Some people say to me: isn't there a cost in providing tax incentives for oil and gas? Yes. It is a little bit like paying an insurance premium on a house to protect yourself against fire. There is a price paid, but the price not to do it is even higher, such as suddenly having long lines at the gas pump again. The same kind of a situation that developed in 1973 and 1974 when we lost in five years some $700 billion worth of income in this country and had an incredible increase in inflation would happen again. We saw all kinds of jobs lost. That is the cost of not protecting ourselves, and that is the real cost that we have to guard against.

We have some highly qualified witnesses here. The chairman has done an excellent job in that selection. I am looking forward to hearing from them.

Senator Boren. Thank you very much, Senator Bentsen. And I think your remarks should be heeded by those that are making policy. We cannot afford to wait. The tragic waste that has already occurred is indeed alarming.

Senator Bentsen has said that we are here today to discuss in some detail the repeal of the so-called windfall profits tax, removal of other disincentives to domestic production found in the Tax Code, and, finally, to analyze limited tax credits to encourage domestic drilling and the replacement of oil and gas reserves.

Briefly, let me set the stage for today's hearing. Really, Senator Bentsen has already done that very eloquently. He said in 1981 there were some 4,500 drilling rigs looking for additional oil and gas reserves in the United States. Today, according to the very latest figures, there are approximately 760—a little less than 760—rigs operating.

In 1981, we were importing only 20 percent of our energy needs from foreign sources. Today, that number has doubled to over 40 percent. At the same time, our consumption has increased by over 500,000 barrels per day in less than 18 months. And yet, our domestic production has decreased by over 800,000 barrels per day during the same period. That means a net loss of 1.3 million barrels per day. When this is added to the fact that 80 percent of the oil service industry has been dismantled, and over 120 refineries have had their doors closed, it should be obvious to even the most casual of observers that something must be done to stop the hemorrhaging in this vital industry.

The so-called windfall profits tax, which is, plain and simple, an excise tax in the production of crude oil in the United States, has drained over $77 billion away from our domestic energy industry in just five and a half years. The tax, in fact, failed to raise any revenue since the second quarter of 1986. Under current law, this excise tax will begin to phase out in January of 1991. However, even under the highest price scenario envisioned in the Department of Energy by the Department of Energy in their energy security report to the President, this tax will fail to raise a single penny between now and 1991. And while the federal government has not raised a cent from this particular tax during the past 12 months, not only have small independent producers in States like Oklahoma encouraged substantial record keeping costs, but the Treasury Department's Internal Revenue Service has no doubt encouraged millions of dollars of expenses keeping track of all this superfluous paperwork.

It is high time that we repeal this onerous and destructive tax which is doing nothing to help the country and is simply draining the resources of both the government and the private sector in needless record keeping and paper shuffling.

It is my objective today to take the discussion of our domestic energy industry beyond the obvious action of repeal of the so-called windfall profits tax to the not so obvious need for renewed incentives to replace our dwindling reserve base.

We will hear testimony today urging a small tax credit for a broad range of drilling expenses. The Joint Tax Committee has analyzed the 50 percent credit for wildcat drilling only. The fact remains that domestic drilling has been reduced by at leat 80 percent over the past several years. So unless we maintain a minimal amount of activity during these difficult times we run the risk of being subject to the economic whims of those in other countries.

Finally, we will hear testimony advocating the removal from the Tax Code various small disincentives—small but important, but particularly in their cumulative effect—of the continued production of marginal properties, as well as additional items designed to enhance such production. Such items include the repeal of the proven property transfer rule, repeal of the 50 percent net income and 65 percent taxable income limitations for percentage depletion deductions. These are measures that are currently working a hardship on small independent producers as they struggle to maintain the production of hundreds of thousands of stripper wells.

These stripper wells are located in some 29 states across the country.

Additionally, we will look at a proposal to permit the expensing of geological and geophysical costs. By allowing the deductibility of these costs instead of the current capitalization, the basic cost of exploratory and developmental drilling would be reduced and we could have more drilling undertaken.

The time has come to take action. We won't be able to solve all of the problems with the proposals that are before us today for discussion; however, the action that results from this hearing will begin to lay a foundation upon which we can base our long-term energy plans.

At this point in time, I would like to enter into the record so that we may have a description of those proposals before us, the report of the Joint Committee on Taxation and their description of the tax proposals relating to domestic oil and gas production, make them a part of the record at this time.

[The information follows:]

DESCRIPTION OF TAX PROPOSALS RELATING TO DOMESTIC OIL AND GAS PRODUCTION AND ENERGY SECURITY

Scheduled for a Hearing

before the

SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

of the

SENATE COMMITTEE ON FINANCE

ON JUNE 5, 1987

INTRODUCTION

The Senate Finance Subcommittee on Energy and Agricultural Taxation has scheduled a public hearing on June 5, 1987, on five energy-related tax proposals: (1) S. 200 and S. 255 (repeal of the crude oil windfall profit tax); (2) S. 233 (primarily relating to oil and gas income tax provisions); (3) S. 846 (provisions relating to oil and gas income taxation and repeal of the crude oil windfall profit tax); (4) tax incentive options contained in the Department of Energy report on energy security, March, 1987;[1] and (5) recommendations for tax legislation contained in the President's May 6, 1987 message to the Congress on energy and national security concerns related to oil import levels.

The first part of the pamphlet[2] is a summary of the proposals. The second part is a description of the proposals by subject area, including present law, explanation of the proposal, and analysis of selected issues.

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[1] United States Department of Energy, *Energy Security: A Report to the President of the United States*, March, 1987.

[2] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Tax Proposals Relating to Domestic Oil and Gas Production and Energy Security* (JCS-14-87), June 4, 1987.

I. SUMMARY

A. S. 200—Senators Nickles, Bentsen, Dole, Wallop, and others; and S. 255—Senators Boren and Bingaman

Repeal of Crude Oil Windfall Profit Tax

Present law imposes an excise tax (the crude oil windfall profit tax) on the windfall profit element of domestically produced crude oil. The tax is scheduled to phase out over a 33-month period beginning in January 1991, or earlier if revenues exceed a specified amount.

The bills (S. 200 and S. 255) would repeal the crude oil windfall profit tax. S. 200 would be effective for oil removed after December 31, 1986, and S. 255 would be effective for oil removed after the date of enactment.

B. S. 233—Senators Boren, Bingaman, Nickles, and Wallop

Income Tax Amendments Related to Domestic Oil and Gas Production

This bill would provide additional income tax incentives for domestic oil and gas production. Among these, the bill would increase the percentage depletion rate if the taxpayer's average removal price for crude oil is less than $20 per barrel, repeal the 50 percent of net income limitation on percentage depletion, and allow transferred properties to qualify for percentage depletion. (A similar anti-transfer rule also would be repealed for windfall profit tax purposes.) The bill also would eliminate recapture of intangible drilling and development costs ("IDCs") upon disposition of an oil, gas or geothermal property, and treat geological and geophysical ("G&G") costs and surface casing costs as expensible IDCs.

These provisions generally would be effective on the date of enactment, except that the increase in the percentage depletion rate (if applicable) would be effective for calendar years beginning after 1986.

C. S. 846—Senators Nickles and Wallop

Energy Security Act of 1987

This bill would repeal the crude oil windfall profit tax and, additionally, provide further income tax incentives for domestic oil and gas production. Among these, the bill would allow percentage depletion at a 27.5-percent rate for domestic new, enhanced, and stripper production (whether or not held by an independent producer or royalty owner); increase the net income limitation on percentage depletion, from 50 to 100 percent; and allow transferred properties to qualify for percentage depletion. (Transferred properties could also qualify for the independent producer stripper well exception to the windfall profit tax.) The bill further would treat G&G costs as expensible IDCs, and would exclude IDCs from the list of preference items for purposes of the alternative minimum tax. Finally, the bill would apply a 3-year statute of limitations on windfall profit tax assessments in certain cases of underwithholding of tax, where the producer did not file a required tax return.

These provisions generally would be effective on the date of enactment. The allowance of percentage depletion for domestic new, enhanced, and stripper production would apply to production during the taxpayer's first full taxable quarter after the date of enactment.

D. Department of Energy Report

The March 1987 Department of Energy report on energy security ("DOE report") provides a comprehensive analysis of the world and domestic energy outlook, and evaluates various tax and other options for addressing energy security concerns. Tax incentives discussed in the DOE report include repeal of the crude oil windfall profit tax; an increase in the percentage depletion rate from 15 to 27.5 percent, either for independent producers and royalty owners (as under present law) or for all new domestic production; an increase in the net income limitation, from 50 to 100 percent; repeal of the percentage depletion anti-transfer rules; treatment of G&G costs as expensible IDCs; and a 5-percent income tax credit, either (1) for all drilling and exploration costs or (2) for G&G expenditures only. The report assesses the advantages and disadvantages associated with each of these options and estimates the revenue loss, as well as the increased oil and gas production, likely to result from each option; however, it does not specifically recommend any option.

E. President's Proposal

In a message to the Congress on May 6, 1987 (the "President's proposal"),[3] President Reagan made three recommendations for tax legislation to strengthen the domestic oil industry. The President's tax proposals include: (1) repealing the crude oil windfall profit tax, effective October 1, 1987 (also included in the President's FY 1988 Budget); (2) increasing the net income limitation on percentage depletion, from 50 to 100 percent of net income from the property; and (3) allowing transferred property to qualify for percentage depletion. The message also proposed various non-tax measures.

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[3] This message was sent to the Congress pursuant to section 3102 of the Consolidated Omnibus Reconciliation Act of 1986 (P.L. 99-509), which directed the President to transmit his views of legislative and/or administrative action necessary to prevent imports of crude oil and petroleum products from exceeding a level that threatens national security. The Department of Energy report (summarized in D., above), which preceded the President's message, also was prepared pursuant to the requirements of P.L. 99-509.

II. DESCRIPTION OF PROPOSALS

A. Crude Oil Windfall Profit Tax Proposals

1. Repeal of crude oil windfall profit tax

Present Law

Present law (Code secs. 4986-4998) imposes an excise tax (the crude oil windfall profit tax) on the windfall profit element of the price of domestically produced crude oil when it is removed from the premises on which it was produced. Generally, the windfall profit element is defined as the excess of the sale price over the sum of the adjusted base price plus the applicable state severance tax adjustment. The windfall profit element may not exceed 90 percent of net income attributable to a barrel of crude oil.

The tax rates and recent base prices applicable to taxable crude oil are as follows:

Category of oil	Tax rate (percent)	Estimated base price [1] (dollars per barrel)
Tier-1 Oil (oil not in tiers 2 or 3):		
Integrated producer	70	$18.85
Independent producer	50	19.44
Tier-2 Oil (Stripper and Petroleum Reserve oil):		
Integrated producer	60	21.29
Independent producer	30	NA
Tier-3 Oil:		
Newly discovered oil	[2] 22.5	28.54
Incremental tertiary oil	30	28.07
Heavy oil	30	23.91

[1] Estimate for third quarter of 1987 based on *SOI Bulletin* (Summer 1986). Tier-1 oil excludes North Slope oil.

[2] Phases down to 20 percent in 1988 and 15 percent in 1989 and subsequent years.

Independent producer stripper well oil is exempt from the tax. Additionally, crude oil from a qualified governmental or a qualified charitable interest, certain front-end oil, certain Indian oil, certain Alaskan oil and, in the case of qualified royalty owners, up to three barrels per day of royalty production, are exempt from the tax.

The windfall profit tax is scheduled to phase out over a 33-month period, beginning after December 31, 1987, if the cumulative revenue raised by the tax reaches $227.3 billion, but in any event beginning no later than January, 1991. As of September 1986, $79 billion of windfall profit tax had been collected.

Proposals

Legislative proposals (S. 200, S. 255, and S. 846)

S. 200 (Senators Nickles, Bentsen, Dole, Wallop, and others), S. 255 (Senators Boren and Bingaman), and S. 846 (Senators Nickles and Wallop) would each repeal the crude oil windfall profit tax. The repeal in S. 255 and S. 846 would be effective for crude oil removed after the date of enactment, while that in S. 200 would be effective for crude oil removed after December 31, 1986.

DOE report

The DOE report includes repeal of the windfall profit tax as a possible tax option.

President's proposal

The President's proposal recommends repeal of the windfall profit tax, effective October 1, 1987.

Analysis

Revenues

One of the main arguments in favor of repealing the windfall profit tax is that at present price levels, the tax raises little or no revenue; yet producers must nevertheless incur the burdensome recordkeeping expenses associated with the tax. Based on the Congressional Budget Office's most recent forecast of petroleum prices, the windfall profit tax will raise little or no revenue over the next five years.

In response, it is argued that the price of oil is extremely volatile and that past attempts to predict future oil prices have been fraught with error.

Effect on exploration and production

Another argument for repealing the windfall profit tax is that it discourages exploration and production of domestic oil. The windfall profit tax is in effect a sales tax on domestic crude oil which cannot be passed on to the consumer since the price of petroleum is set by foreign producers who are not subject to the tax. As a result of the tax, high cost oil may not be produced, and exploration activities may be reduced. The disincentive effect of the windfall profit tax may be offset by the percentage depletion allowance which is, in effect, a tax subsidy based on sales (i.e., a negative excise tax). However, it is hard to justify a tax system which simultaneously encourages and discourages crude oil production.

In response, it is argued that the windfall profit tax minimizes adverse effects on exploration and development by setting high base prices and lower tax rates for newly discovered, incremental tertiary, heavy, and stripper well oil.

Oil price decontrol

In April of 1979, the Carter Administration announced that it would use its discretionary authority over oil prices to phase out price controls between June 1, 1979 and September 30, 1981. Members of Congress who favored price controls did not seek legislation against decontrol in return for Administration support of a tax on a portion of the profits attributable to decontrol. The Crude Oil Windfall Profits Tax Act of 1980 is a result of this compromise.

Repeal of the Crude Oil Windfall Profit Tax Act might breach the compromise reached in 1980. However, the inflation-adjusted price of oil is now less than half of what it was when the Crude Oil Windfall Profit Tax Act was enacted: this change in circumstances might justify repeal or modification of the Act.

2. Repeal of anti-transfer rule

Present Law

Independent producer stripper well oil attributable to a working interest in the property is exempt from the crude oil windfall profit tax (sec. 4994(g)). This exception does not apply to any proven property that was owned after July 22, 1981, by a person other than an independent producer, and subsequently transferred to an independent producer.

Proposals

S. 233 (Senators Boren, Bingaman, Nickles, and Wallop), and S. 846 (Senators Nickles and Wallop)

S. 233 and S. 846 would repeal the anti-transfer rule for purposes of the independent producer stripper well exemption, effective for crude oil removed after the date of enactment.

Analysis

When the Congress enacted the Crude Oil Windfall Profit Tax in 1980, an exemption was provided for independent producers stripper well oil. The anti-transfer rule was designed to prevent integrated producers from indirectly benefiting from the windfall profit tax exemption by selling proven stripper well properties to independent producers. Congress also was concerned that revenues from the tax could be reduced significantly by tax-motivated transfers of proven properties.

Repeal of the transfer rule would have little effect on exploration (since new oil is taxed at the same rate for both independent and integrated producers) and would do little to increase current production (since there is little or no windfall profit at current oil prices). Independent producers only would benefit from repeal of the anti-transfer rule on properties acquired from integrated producers if the price of oil increases above current levels.

3. Statute of limitations for certain underpayments of tax

Present Law

Except as provided in regulations, the windfall profit tax is withheld by the first purchaser of the oil from the price paid for the oil. The producer generally is required to file a return (Form 720) only if its windfall profit tax liability exceeds the amount of tax withheld during the calendar year. When required, Form 720 must be filed not later than May 31 of the next succeeding calendar year.[4]

If a producer is not required to file Form 720, the statute of limitations for assessment (or refund) of windfall profit tax runs three years from the due date of the producer's income tax return for the taxable year in which the removal year ends. If a Form 720 was filed, the limitation period runs for three years from the due date of that form.

In Rev. Rul. 85-37, 1985-1 C.B. 362, the IRS took the position that, if Form 720 was required to be filed (e.g., because of an underwithholding of windfall profit tax), but was not filed, the period for assessment is unlimited.

Proposal

S. 846 (Senators Nickles and Wallop)

Under S. 846, for statute of limitations purposes, the producer would not be treated as having been required to file a windfall profit tax return, if the amount of tax withheld by the first purchaser with respect to any oil was not less than the amount required to withheld as shown on the return filed by the first purchaser. Thus, in such cases, a three-year statute of limitations would apply, measured from the due date of the producer's income tax return.

This provision would be retroactive to the original effective date of the windfall profit tax.

Analysis

An unlimited assessment period generally is applied in cases where the IRS could not reasonably be expected to have notice of a taxpayer's failure to pay the correct amount of tax (e.g., in the case of failure to file a required return). Allowing a limited assessment period where no return was filed would be contrary to this policy. On the other hand, it may be argued that a producer who relied on the first purchaser's finding that no windfall profit tax was due should be treated in the same manner as a producer that was not required to file a return.

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[4] The first purchaser of oil is required to file quarterly returns of withheld tax, including information necessary to facilitate coordination of withholding by the purchaser with the determination of tax on the producer of the oil.

B. Income Tax Proposals

1. Proposals relating to drilling costs

a. Tax credit for drilling expenditures

Present Law

Intangible drilling and development costs generally

Costs incurred by an operator to develop an oil or gas property for production are of two types: (1) intangible drilling and development costs, and (2) depreciable costs. The acquisition price for the oil- or gas-producing property, and geological and geophysical costs are recovered through depletion deductions (see discussion below).[5]

Under present law, domestic intangible drilling and development costs ("IDCs") may either be currently expensed or else may be capitalized and recovered through depletion or depreciation deductions (as appropriate), at the election of the operator. In general, IDCs include expenditures by the property operator incident to and necessary for the drilling and the preparation of wells for the production of oil or gas (or geothermal energy) which are neither for the purchase of tangible property nor part of the acquisition price of an interest in the property.

IDCs include amounts paid for labor, fuel, repairs, hauling, supplies, etc., to clear and drain the well site, make an access road, and do such survey and geological work as is necessary to prepare for actual drilling. Other IDCs are paid or accrued by the property operator for the labor, etc., necessary to construct derricks, tanks, pipelines, and other physical structures used to drill the wells and prepare them for production. IDCs include amounts paid or accrued to drill, shoot, and clean the wells. IDCs also include amounts paid or accrued by the property operator for drilling or development work done by contractors under any form of contract.

Only persons holding an operating interest in a property are entitled to deduct IDCs. This includes an operating or working interest in any tract or parcel of oil- or gas-producing land either as a fee owner, or under a lease of any other form of contract granting working or operating rights. In general, the operating interest in an oil or gas property must bear the cost of developing and operating the property. The term operating interest does not include royalty interests or similar interests such as production payment rights or net profits interests.

Generally, if IDCs are not expensed, they can be recovered through depletion or depreciation, as appropriate. If IDCs are capitalized, costs paid or incurred with respect to a nonproductive well ("dry hole") may nonetheless be deducted as an ordinary loss, at the election of the operator, in the taxable year in which the dry hole is completed.

No tax credit is provided for IDCs or similar expenses under present law.

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[5] Amounts paid or accrued during the development of a property to acquire tangible property ordinarily considered to have a salvage value (e.g., tools, pipe, cases, tubing, engines, etc.) are recovered through depreciation deductions. No election is permitted with respect to these costs.

Thirty-percent reduction for integrated producers

In the case of a corporation which is an integrated oil company (i.e., which is not an independent producer)[6] the allowable deduction with respect to domestic IDCs is reduced by 30 percent. The disallowed amount must be added to the basis of the property and amortized over a 60-month period, starting with the month in which the costs are paid or accrued. Amounts paid or accrued with respect to nonproductive wells (dry hole costs) are fully deductible in the taxable year in which the nonproductive well is completed.

Treatment of foreign IDCs

Under a provision added by the Tax Reform Act of 1986, IDCs incurred with respect to properties located outside the United States do not qualify for expensing. Instead, these costs must be recovered (1) using 10-year, straight-line amortization beginning in the year paid or incurred, or (2) at the taxpayer's election, as part of the basis for purposes of any deduction allowable under section 611.[7]

Proposal

DOE report

The DOE report includes an option to provide a 5-percent income tax credit for all exploration and drilling expenditures. These would include intangible drilling and development costs and, additionally, geological and geophysical ("G&G") costs in connection with oil and gas properties (*see also*, II.B.3, below).

Analysis

An argument in favor of an oil and gas exploration tax credit is that the market may fail to generate a socially desirable level of investment in high risk and research-related activities. For example, the Code reflects this view by providing a 20-percent credit for increases in research and experimental expenditures.

In addition, some argue that the social cost of using oil exceeds its market price. The excess cost, or "premium", is attributable to the national security cost of oil use (including the cost of maintaining the strategic petroleum reserve), and the impact of increased U.S. petroleum consumption on the world petroleum market. Since the market price does not reflect the premium value of crude oil, according to this theory, domestic producers may fail to invest adequately in oil exploration. In this case, tax incentives for exploration and development may be desirable to achieve an adequate supply of petroleum.

Since a tax credit provides only a small benefit to taxpayers with little tax liability, it may be less efficient than a subsidy delivered through a direct spending program. In particular, given current oil prices, independent oil producers may receive relatively less benefit from the credit than integrated producers since, independents generate little or no income from refining or retailing operations. Also, independent producers benefit from full expensing of IDCs and the use of percentage depletion (although these benefits may be limited by the alternative minimum tax).

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[6] These terms are defined in the same manner as for purposes of percentage depletion (discussed in II.B.2.).

[7] *See*, the discussion of depletion, in II.B.2., below.

b. Recapture of IDCs and depletion

Present Law

When a taxpayer disposes of oil, gas, or geothermal property, a portion of the gain must be treated as ordinary income instead of capital gain (sec. 1254). For property placed in service on or after January 1, 1987, the amount subject to such "recapture" is equal to the lower of (1) the amount of IDCs deducted (which, but for being deducted, would have been reflected in the adjusted basis of the property), plus depletion deductions that reduce the adjusted basis of the property, or (2) the gain on the sale, exchange, or involuntary conversion of the property.

For property placed in service before January 1, 1986,[8] the recapture amount is equal to the lower of (1) the amount of IDCs deducted since January 1, 1976 (which, but for being deducted, would have been reflected in the adjusted basis of the property), reduced by the amount (if any) by which the depletion deduction with respect to such property would have been increased if such amounts had been capitalized, or (2) the gain on the sale, exchange, or involuntary conversion of the property. Thus, for such property, IDC (but not depletion) deductions are recaptured upon disposition of the property.[9]

Proposal

S. 233 (Senators Boren, Bingaman, Nickles, and Wallop)

S. 233 would repeal the rules providing for recapture of intangible drilling cost deductions upon disposition of an oil, gas or geothermal property (sec. 1254). This repeal also would apply to the recapture of certain depletion deductions on property placed in service after 1986.[10]

This provision would be effective for dispositions of oil, gas or geothermal properties after the date of enactment.

Analysis

Under the Tax Reform Act of 1986, gain from the sale of oil, gas, and geothermal property attributable to deductions for intangible drilling costs and depletion allowances are treated as ordinary income rather than capital gain. Since ordinary income and capital gains are taxed at the same rate after 1987, the effect of the recapture rule is to prevent recapture income from being sheltered by capital losses for taxpayers with net capital losses (or capital loss carryforwards).

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[8] This rule also applies to property acquired pursuant to a binding, written contract in effect on September 25, 1985.

[9] Under the Tax Reform Act of 1986, the capital gain rate for individuals is conformed to the rates on ordinary income, effective in calendar year 1988. For calendar year 1987, a maximum 28-percent rate applies. The capital gain rate for corporations is 34 percent for gain recognized on or after January 1, 1987.

[10] The bill would not affect recapture of mining exploration and development costs (secs. 617(d) and 1254).

Under the 1986 Act, the recapture rules for oil and gas property were made more similar to the rules applicable to depreciable property. S. 233 would afford oil and gas property more favorable recapture treatment than depreciable property—treatment that actually would be more beneficial to the taxpayer than the rules in existence before the 1986 Act.

c. Repeal of IDC minimum tax treatment

Present Law

IDC deductions on successful oil and gas wells are a tax preference item for purposes of the individual and corporate alternative minimum taxes, to the extent that the taxpayer's excess IDCs exceed 65 percent of the taxpayer's income from oil and gas properties. (Geothermal properties are treated in a similar manner.) Excess IDCs are defined generally as (1) IDC deductions (attributable to successful wells) for the taxable year, minus (2) the amount that would have been deductible in that year had the IDCs been capitalized and recovered over a 10-year, straight-line amortization period. At the election of the operator, the cost depletion method may be substituted for the 10-year amortization schedule in determining the amount of tax preference.

IDCs are not treated as a tax preference item if the taxpayer elects to amortize IDCs over a 10-year period.

Proposal

S. 846 (Senators Nickles and Wallop)

S. 846 would repeal the treatment of excess IDCs as a minimum tax preference item, effective for costs paid or incurred after the date of enactment.

Analysis

The alternative minimum tax enacted in the Tax Reform Act of 1986 requires that taxpayers pay a minimum rate of tax (21 percent for individuals and 20 percent for corporations) on a broad measure of their economic income. Repeal of the tax preference for excess IDCs would allow some producers to reduce their effective rate of tax below 21 or 20 percent (for individual and corporate taxpayers, respectively).

An argument in favor of the proposal is that it would increase the tax incentive for incurring drilling expenditures for producers that are subject to minimum tax. To the extent that repeal of the IDC preference allows producers to shelter most or all of their income from tax, however, other taxpayers may view the Tax Code as inequitable. Also, allowing an exception to the alternative minimum tax for the oil and gas industry might be a precedent for other industries seeking exceptions from the minimum tax.

d. Treatment of surface casing costs

Present Law

IDCs generally are limited to expenditures for items which do not have a salvage value (Treas. Reg. sec. 1.612-4(a)).

The Internal Revenue Service has ruled that, under present law, the cost of casing (including surface and production casing) and associated equipment must be capitalized and recovered through depreciation deductions, since the casing is deemed to have a salvage value.[11] Labor and other costs of installing the casing may be deducted as IDCs.

Proposal

S. 233 (Senators Boren, Bingaman, Nickles, and Wallop)

Under S. 233, surface casing costs would be treated as IDCs for tax purposes, effective for costs paid or incurred after the date of enactment.

Analysis

Surface casing generally is installed only after the producer has determined that production from the well is commercially viable. Allowing surface casing costs to be expensed rather than capitalized would tend to encourage development of proven properties. Thus, the proposal probably would increase oil and gas production, but only would indirectly affect exploration activity.

A general tax policy principle is that the costs of acquiring or producing an asset with a useful life or more than one year should be capitalized rather than expensed. Under present law, an exception from this principle is made in the case of IDCs. The proposal would expand this exception, increasing the preferential tax treatment of the oil and gas industry relative to other sectors of the economy.

2. Proposals relating to depletion

a. Increase in percentage depletion rate

Present Law

General rules

Certain costs incurred prior to drilling an oil- or gas-producing property are recovered through depletion deductions. These include costs of acquiring the lease or other interest in the property, and geological and geophysical costs. Depletion is available to any person having an economic interest in a producing property (including a royalty interest).

Depletion is computed using whichever of two methods results in a higher deduction: cost depletion or percentage depletion.

Under the cost depletion method, the taxpayer deducts that portion of the adjusted basis of the property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining to be recovered at the beginning of the taxable year. The amount recovered under cost depletion cannot exceed the taxpayer's basis in the property.

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[11] *See,* Rev. Rul. 70-414, 1970-2 C.B. 132; Rev. Rul. 78-13, 1978-1 C.B. 63.

Under percentage depletion, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year. The amount deducted may not exceed 50 percent of the taxable income from the property for the taxable year, computed without regard to the depletion deduction (the "net income limitation"). Additionally, the deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and trust distributions).[12] Because percentage depletion is computed without regard to the taxpayer's basis in a property, cumulative depletion deductions may be greater than the amount expended by the taxpayer to acquire or develop the property.

Percentage depletion, to the extent it exceeds the adjusted basis of the property, is treated as a preference item for purposes of the individual and corporate alternative minimum taxes.

Limitation to independent producers, etc.

Under present law, percentage depletion for oil and gas properties is limited to independent producers and royalty owners [13] (as opposed to integrated oil companies), for up to 1,000 barrels of average daily domestic crude oil production, or an equivalent amount of domestic natural gas.[14] For producers of both oil and natural gas, this limitation applies on a combined basis.[15]

For purposes of percentage depletion, an independent producer is any producer who is not a "retailer" or "refiner." A retailer is any person who directly, or through a related person, sells oil or natural gas or any product derived therefrom (1) through any retail outlet operated by the taxpayer or related person, or (2) to any person obligated to market or distribute such oil or natural gas (or product derived therefrom) under the name of the taxpayer or the related person. (Bulk sales to commercial or industrial users, and bulk sales of aviation fuel to the Department of Defense, are excluded for this purpose.) Further, a person is not a retailer within the meaning of this provision if the combined gross receipts of that person and all related persons from the retail sale of oil, natural gas, or any product derived therefrom do not exceed $5 million for the taxable year.

A refiner is any person who directly or through a related person engages in the refining of crude oil, but only if such taxpayer or related person has a refinery run in excess of 50,000 barrels per day on any day during the taxable year.

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[12] Amounts disallowed as a result of this rule may be carried forward into later taxable years.

[13] Under a provision added by the Tax Reform Act of 1986, percentage depletion is not available for lease bonuses, advance royalties, or other amounts paid without regard to actual production from a property.

[14] As originally enacted, the depletable oil quantity was 2,000 barrels of average daily production; however, this was phased down to 1,000 barrels for 1980 and thereafter.

[15] Certain regulated natural gas, natural gas sold under a fixed contract, and natural gas from geopressured brine is exempt from the 1,000 barrel per day limitation.

Similar depletion rules apply to geothermal deposits located in the United States, except that the 1,000-barrel-per-day and 65 percent of taxable income limitations do not apply to such deposits.

Proposals

S. 233 (Senators Boren, Bingaman, Nickles, and Wallop)

S. 233 would increase the percentage depletion rate for crude oil and natural gas, if the taxpayer's average removal price for oil and gas sold during the calendar year is $20 per barrel or less. The amount of the increase would depend upon the average annual removal price, as shown in the following table:

*If the average annual removal price during the calendar year is:**	*The applicable percentage is:*
Less than $10	30 percent
$10 to $15	25 percent
$15 to $20	20 percent
Greater than $20	15 percent

*These prices are measured in dollars per barrel.

The "average annual removal price" for the taxpayer would be determined by dividing the taxpayer's aggregate production of domestic crude oil or natural gas for the calendar year by the aggregate amount for which such production was sold.[16] In the case of crude oil or natural gas sold between related persons, removed before sale, or refined on the production premises, a constructive sales price would be used (secs. 613 and 4988(c)). For example, if a taxpayer sold 100,000 barrels of crude oil for an aggregate price of $1.8 million in calendar year 1988, the taxpayer's average removal price would be $18 per barrel, and a percentage depletion rate of 20 percent would apply to all production by that taxpayer in 1988.

Percentage depletion would continue to be limited to 1,000 barrels per day of domestic crude oil production (or an equivalent amount of natural gas) by independent producers.[17] Additionally, the limitation on percentage depletion deductions for all oil and gas properties, to 65 percent of the taxpayer's overall taxable income, would remain in effect.[18]

The changes in the percentage depletion rate would be effective for production during calendar years beginning after December 31, 1986.

S. 846 (Senators Nickles and Wallop)

S. 846 would provide a 27.5-percent depletion rate with respect to a taxpayer's domestic new, enhanced, or stripper production, as defined under the bill. This deduction would be available to all taxpayers (including independent and integrated producers), for an unlimited amount of production; however, it would be limited to 100 percent [19] of net income from the property and 100 percent [20] of the taxpayer's adjusted taxable income. Additionally, as under the independent producer exception, percentage depletion would not be available for lease bonus or advance royalty payments.

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[16] The legislation apparently intends that the average annual removal price be determined by dividing removal production in barrel-of-oil equivalents into (rather than by) the amount for which such production was sold.

[17] The bill would repeal the anti-transfer provisions for purposes of this limitation (see discussion in II.B.2.c., below).

[18] The 50-percent net income limitation would be repealed under S. 233, as described in II.B.2.c., below.

For purposes of the bill, new production would include production from any property (as defined for percentage depletion purposes) that commences production after March 31, 1987. Enhanced production would include (1) the increase in average daily production for the taxable year over average daily production for the period January 1, 1987, through March 31, 1987, and (2) incremental tertiary oil as defined for windfall profit tax purposes (sec. 4993(a)). Stripper production would include production from any stripper well property as defined in the June 1979 energy regulations.

This provision would be effective for production during the taxpayer's first full taxable quarter following the date of enactment.

DOE report

The DOE report includes two options to increase the percentage depletion rate for oil and gas properties:

(1) Higher percentage depletion for independent producers and royalty owners.—Under this option, percentage depletion for oil and gas properties would continue to be available only to independent producers and royalty owners, for a maximum of 1,000 barrels per day of production. However, the percentage depletion rate for such properties would be increased, from 15 to 27.5 percent.

(2) Higher percentage depletion for new production.—This option would allow all taxpayers (including independent and integrated producers) to take percentage depletion on an unlimited amount of new domestic oil and gas production, at a 27.5-percent rate. To limit the increase in deductions that would result from higher prices, the report suggests the possibility of a sunset provision, under which present-law rules would be restored if oil prices exceeded a specified level for a 12-month period.

Analysis

Under S. 233, the rate of percentage depletion for oil and gas would be increased from 15 percent to 30 percent as the average annual removal price of oil falls from $20 to $10 per barrel. The effect is to increase the rate of percentage depletion when the income of domestic producers falls due to declining world oil prices. Other proposals (S. 846 and the DOE report) would increase the percentage depletion rate under specified circumstances.

An argument in favor of a variable rate of percentage depletion is that it would tend to stabilize the income of oil and gas producers. This provision is similar to certain agriculture stabilization programs which increase payments to farmers when farm income falls as a result of oversupply. However, such a policy would tend to destabilize the world petroleum market by encouraging domestic production when the world market is confronted by a glut. This could make it more difficult for the major oil-importing countries to coordinate energy policies.

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[19] This would replace the present-law 50-percent limitation under S. 846 (*see*, II.B.2.c., below).
[20] This would replace the present-law 65-percent limitation under S. 846 (*see*, II.B.2.c., below).

Increasing the rate of percentage depletion would provide little or no benefit to many of the oil and gas producers hardest hit by falling petroleum prices: those producers with net operating losses. Additional depletion deductions have no immediate value to producers without income tax liability. Increasing the rate of percentage depletion on oil produced from existing wells would encourage more rapid depletion of these reservoirs, but would not encourage additional oil and gas exploration activity.

b. Repeal of anti-transfer rule

Present Law

Percentage depletion for oil and gas properties is limited to independent producers, for up to 1,000 daily barrels of oil production (or an equivalent amount of natural gas).

To prevent proliferation of the independent producer exception, all production owned by businesses under common control, or by members of the same family, must be aggregated for purposes of these rules. Further, if an interest in a proven oil or gas property is transferred after 1974, production from such interest does not qualify for percentage depletion. Exceptions to this anti-transfer rule are provided in the case of transfers at death, to controlled corporations, and between controlled corporations or certain other business entities.

Proposals

S. 233 (Senators Boren, Bingaman, Nickles, and Wallop)

S. 233 would repeal the anti-transfer provision for purposes of the 1,000 barrel per day limitation on percentage depletion. Thus, proven oil and gas properties could be transferred to an independent producer and qualify for percentage depletion. Percentage depletion would continue to be limited to 1,000 barrels of average daily production by each transferee (including production from transferred and other properties).

The repeal of the percentage depletion anti-transfer rule would be effective for production after the date of enactment, in taxable years ending after that date.

S. 846 (Senators Nickles and Wallop)

S. 846 would repeal the percentage depletion anti-transfer provision, effective for transfers taking place after the date of enactment.

DOE report

The DOE report includes an option to repeal the percentage depletion anti-transfer rule. It suggests that, in order to limit the transfer of more profitable properties, repeal of the anti-transfer rule could be restricted to stripper wells.

President's proposal

The President's proposal recommends repeal of the percentage depletion anti-transfer provision.

Analysis

Since 1975, the use of the percentage method for computing depletion deductions for oil and gas wells has been restricted to independent producers and royalty owners for limited amounts of crude oil and natural gas.

At the time these restrictions were enacted, Congress recognized that taxpayers would attempt to maximize the amount of oil and gas eligible for percentage depletion by transferring ownership interests. Consequently, the 1975 Act specifies that the limitation on the amount of oil and gas eligible for percentage depletion is to be computed by aggregating the production of related parties. In addition, the 1975 Act generally disallows percentage depletion with respect to transfers of proven oil and gas property.

The anti-transfer rules prevent integrated producers from indirectly obtaining the benefits of percentage depletion by selling productive oil and gas property to independents. The anti-transfer rules also prevent independent producers with less than 1,000 barrels per day of average production from buying proven reserves in order to use up their percentage depletion limitation.

An argument for repeal of the anti-transfer rule is that by expanding the amount of oil and gas eligible for percentage depletion, the Tax Code would provide a more powerful incentive for production, and might prevent the abandonment of marginal wells that otherwise would be permanently closed. Oil and gas exploration activities also would be expected to increase as a result.

An argument against repeal of the anti-transfer rules is that integrated producers would be able to benefit indirectly from percentage depletion by selling reserves to independents. A substantial portion of the revenue loss attributable to this provision would result from the transfer properties that are already developed, rather than the transfer of newly-discovered oil and gas properties.

c. Repeal of or increase in net income and 65 percent limitations

Present Law

Percentage depletion deductions with respect to an oil, gas, or hard mineral property may not exceed 50 percent of the taxable income from the property for the taxable year (the "net income limitation"). Additionally, the deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before such deduction and adjusted for certain loss carrybacks and trust distributions). Amounts disallowed under this latter rule may be carried forward to later taxable years.

Proposals

S. 233 (Senators Boren, Bingaman, Nickles, and Wallop)

S. 233 would repeal the 50 percent of net income limitation on percentage depletion deductions for oil and gas properties. Thus, percentage depletion would equal the specified percentage of gross income from each property, without regard to the net income from that property. The overall limitation to 65 of adjusted taxable income would continue to apply.

The repeal of the net income limitation would be effective for taxable years beginning after the date of enactment.

S. 846 (Senators Nickles and Wallop)

S. 846 would increase the 50 percent of net income limitation to a 100-percent limitation, for oil and gas properties only. Under this rule, percentage depletion with respect to an oil or gas property could not exceed 100 percent of taxable income from the property for the taxable year (i.e., the deduction could be used to offset taxable income from the property, but could not offset other income).

The bill would also increase the limit on percentage depletion for all oil and gas properties, to 100 percent (rather than 65 percent) of the taxpayer's adjusted taxable income.

These provisions would each be effective for taxable years beginning after the date of enactment.

DOE report

The DOE report includes an option to increase the net income limitation on oil and gas properties from 50 to 100 percent.

President's proposal

The President's proposal would increase the net income limitation from 50 to 100 percent.

Analysis

The percentage depletion allowance can be viewed as a tax rate reduction. The 50-percent of net income limitation acts to limit the rate reduction to 50 percent of the otherwise applicable income tax rate. For example, where production costs are zero, percentage depletion reduces the tax rate of a 28-percent bracket taxpayer (not subject to alternative minimum tax) to 23.8 percent (85 percent of 28 percent). As production costs rise, the tax rate is reduced from 85 percent of the otherwise applicable tax rate to 50 percent of such tax rate (for production costs at or above 70 percent of gross oil and gas income).[21]

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[21] Consider a 28-percent tax bracket producer with $100 of gross income from oil and gas properties and zero production costs. In this case, net oil and gas income is $100 ($100 of gross income less zero production cost), the percentage depletion deduction is $15 (15 percent of $100), taxable income is $85 ($100 less $15), tax liability on oil and gas income is $23.80 (28 percent of $85), and the effective tax rate is 23.8 percent ($23.80 as a percent of $100 of net income). If production costs are $70, net oil and gas income is $30 ($100 of gross income less $70 of production cost), the percentage depletion deduction is $15 (15 percent of $100), taxable income is $15 ($30 less $15), tax liability on oil and gas income is $4.20 (28 percent of $15.00), and the effective rate is 14 percent ($4.20 as a percent of $30 of net income).

An argument for repealing or modifying the 50-percent of net income limitation is that it effectively eliminates the benefit of percentage depletion for producers who have little or no net income from oil and gas properties as a result of high exploration or production costs. Repeal of the net income limitation would allow percentage depletion deductions to be used against income from non-oil and gas activities, thus providing a potential benefit to producers without net oil and gas income. (Increasing the limitation to 100 percent would not benefit producers without net income from oil and gas properties.)

An additional argument for repealing or modifying the 50-percent limitation is that the alternative minimum tax and passive loss rules provided by the Tax Reform Act of 1986 may be sufficient to prevent excessive use of percentage depletion deductions to shelter income unrelated to oil and gas activities.

The 65-percent limitation acts to limit the sheltering of oil and gas income by unrelated tax losses. For a taxpayer subject to the 65-percent limitation, each dollar of tax loss from activities outside the oil and gas business reduces the taxpayer's percentage depletion deduction by 65 cents, resulting in a net shelter of 35 cents of oil and gas income.

An argument for repealing or modifying the 65-percent limitation is that the alternative minimum tax and passive loss rules provided by the Tax Reform Act of 1986 may be sufficient to prevent excessive use of unrelated tax losses against oil and gas income.

Another argument for repealing or modifying both the 65-percent and 50-percent limitations is that a producer subject to either limitation may have a tax incentive *not* to incur exploratory costs since such costs, in effect, only are partially deductible. This situation arises because each dollar of deductible expense (e.g., exploratory costs) reduces the percentage depletion deduction by 50 cents for a taxpayer at the 50-percent limit, and 65 cents for a taxpayer at the 65-percent limit. Increasing the limitations (for example to 100 percent) would, in effect, make exploratory costs 100-percent nondeductible for taxpayers subject to limitation.

These proposals, by reducing the tax rate on oil and gas income, favor the oil and gas industry over other sectors of the economy, such as agriculture and manufacturing. This may harm the long-run competitiveness of the U.S. economy. In addition, since oil and gas reserves are a finite resource, encouraging production now will reduce domestic supplies in the future.

3. Proposals relating to geological and geophysical ("G&G") costs

a. Faster recovery for G&G costs

Present Law

Under present law, geological and geophysical (G&G) expenditures for the purpose of identifying and locating productive mineral properties must be capitalized and recovered through depletion deductions. These may include expenditures for reconnaissance surveys over a broad area, and more detailed surveys within an identified area of interest. G&G costs may be deducted as an ordinary business loss (sec. 165) if the entire area of a survey is abandoned as a potential source of mineral production.[22]

Proposals

S. 233 (Senators Boren, Bingaman, Nickles, and Wallop)

Under S. 233, domestic (including U.S. possessions) G&G costs would be treated in the same manner as intangible drilling and development costs (IDCs) for tax purposes. Thus, these costs would qualify for expensing at the election of the operator, subject to a 30-percent reduction for integrated oil companies.[23]

S. 846 (Senators Nickles and Wallop)

S. 846 would treat domestic (including U.S. possessions) G&G costs in the same manner as IDCs, effective for costs paid or incurred after the date of enactment.

DOE report

The DOE report includes an option to treat domestic G&G costs in the same manner as IDCs.

Analysis

Under present law, G&G costs generally are recovered less rapidly than IDCs, since IDCs are not required to be capitalized and recovered through depletion deductions. Moreover, G&G costs may not reduce the tax liability of a producer using the percentage depletion method, because percentage depletion deductions are computed without regard to cost basis.

The relatively less generous tax treatment of G&G costs relative to IDCs may be viewed as inequitable. Moreover, to the extent that G&G activity and exploratory drilling are substitutable methods for finding oil and gas reserves, the less favorable treatment of G&G costs relative to IDCs may bias exploration activity against G&G surveys. Expensing of G&G costs would reduce this tax bias against G&G activity.

An argument against expensing of G&G costs is that, under the uniform capitalization rules of the Tax Reform Act of 1986, taxpayers are required to capitalize most costs attributable to the production of inventory property and long-term construction contracts. Expensing of G&G costs would provide significantly more favorable tax accounting treatment to the oil and gas industry than other sectors of the economy.

b. Tax credit for G&G costs

Present Law

No tax credit is provided for G&G costs.

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[22] *See*, Rev. Rul. 77-188, 1977-1 C.B. 76; Rev. Rul. 83-105, 1983-2 C.B. 51.

[23] The minimum tax rules applicable to IDCs also would apply to these costs.

Proposal

DOE report

The DOE report includes an option to provide a 5-percent income tax credit for G&G expenditures.[24]

Analysis

For an analysis of the issued involved in establishing a tax credit for exploratory and drilling expenditures, see the discussion in II.B.1.a., above.

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[24] The report also includes an alternative option to provide a 5-percent credit for all exploration and drilling expenditures (*see*, II.B.1.a., above).

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Senator **Boren**. We are very privileged to have with us this morning, seated at the front table, four of our colleagues in the Senate who are among the most knowledgeable of all the members of the Senate about the need to encourage domestic energy production. It is a great cumulative expertise represented at the table before us and it is a real privilege to have these colleagues appear this morning.

I am first going to call on Senator Bingaman, of New Mexico, to ask that he make an opening comment. Or let me ask, if there are others on a short-time schedule.

Senator **Bingaman**. Senator Gramm has a graduation to attend.

Senator **Boren**. I think we had better start with Senator Gramm then. I think that is an important matter. Are you observing the graduation or speaking to the graduates?

Senator **Gramm**. No. I have a graduate.

Senator **Boren**. You have a graduate.

Senator **Gramm**. Seldom in my family, Mr. Chairman, do we have people graduate from anything. [Laughter.]

Senator **Boren**. Well it is sort of seldom, like in this government, that we ever take those things that are out of date and outmoded like the windfall profits tax off the books.

Senator **Domenici**. Mr. Chairman, seldom do we agree to let him go first, but he has agreed to be very brief.

Senator **Boren**. I realize the risk involved. [Laughter.]

It is a pleasure to have our colleague from Texas with us. Senator Gramm, we will begin with you.

STATEMENT OF THE HON. PHIL GRAMM, U.S. SENATOR FROM THE STATE OF TEXAS

Senator **Gramm**. Thank you, Mr. Chairman.

First, let me say I appreciate having the opportunity to be here. I thank you for holding the hearing. Many of us fought hard to have an energy security study done by the Department of Energy. You can always criticize any study, but I think that study made it clear that we have a problem, not just a problem in Oklahoma, and Texas, and Louisiana, and New Mexico and other oil producing states, but a problem that faces every American consumer and every State in the union.

Frankly, I am disappointed by the decision of the President not to move forward with a stronger program of effective tax incentives to provide more incentives for the production of domestic energy.

Despite the fact that most of us here, if not all of us, are disappointed the President did not go further, I don't think that should lessen our resolve to enact the things that, in fact, he did support. We should also try to put together a package that can supplement that original proposal and give us a real energy proposal.

I think it is vital that we repeal the windfall profit tax. I am more optimistic than apparently the chairman's estimates, in that I believe that we face the very real prospects within a year or so of paying windfall profit taxes. And certainly those investments that are undertaken—the drilling programs that are looked at today—

have to figure into their potential earnings the possibility of paying windfall profits taxes if, in fact, prices should go up.

So I think it is vital that we repeal the windfall profits tax. I think that ought to be a high priority for this Congress. Certainly the President's proposal concerning the transfer rule and income limitation on depletion allowance ought to be enacted. But I believe very strongly that we have got to go further by considering those proposals that can give us an effective return in terms of drilling, in terms of reserve additions, in terms of reduction of foreign oil dependence. I believe that heading that list have to be exploration and marginal production tax credits.

I think we need to expense geological and geophysical costs. There is no logic economically as to why they should be capitalized while we are writing off intangible drilling costs on an expedited basis. I think geological and geophysical costs ought to be expensed.

I think that if we put those proposals together with the President's proposal, we have an efficient package. The costs of that package are relatively low as compared to the ability of that package, if combined with regulatory reform, with repeal of the windfall profit tax, and with some proposal to move toward a full deregulation of natural gas, to yield a million barrels per day reduction in foreign oil dependence. I think that ought to be the minimum we try to do.

I ask my colleagues, especially on this committee, to remember that in the President's message in the final sentence he does keep his options open to look at additional proposals. I am hopeful that we, on a bipartisan basis, can take the President's proposal—I support everything in it; there is just not enough in it—and supplement it with some effective, well-targeted production incentives with a high return to the American consumer relative to the cost. If we can put together a bipartisan proposal and move forward, I am still convinced that we might have an opportunity to induce the Administration to support that proposal. I certainly am willing to work with the chairman of this subcommittee and the distinguished chairman of the Finance Committee, Senator Bentsen, my colleague from Texas, and others, to try to do that.

Senator BOREN. Thank you very much, Senator Gramm. We share that same hope. And I think certainly, speaking for myself, I certainly am in agreement with those proposals the Administration has agreed to accept. They are a product of long discussion of several of us with them. And it includes some of the technical proposals that we have developed in the Finance Committee over a long period of time. And like you, I am hopeful, particularly with the sentence that you quoted, that the door might be opened to take additional measures, because additional measures are going to be necessary if we are going to meet the minimum goal which you described of reducing our reliance by at least a million barrels a day. And I think that is a very reasonable starting point of a goal because we have, in a very alarming way, increased this dependence over the past 18 months. And I appreciate your comments very much.

Since Oklahoma is presiding today, I will ask my colleague from Oklahoma to defer and let our good neighbor from New Mexico go ahead of us. We are privileged to have both Senators from New

Mexico with us today, both Senator Domenici and Senator Bingaman, very, very knowledgeable in this area. And both have been very active year in and year out in bringing proposals to the floor and to this committee to encourage domestic energy activity. And I will recognize the two Senators from New Mexico at this time.

Senator Bingaman, would you proceed?

STATEMENT OF HON. JEFF BINGAMAN, U.S. SENATOR FROM THE STATE OF NEW MEXICO

Senator BINGAMAN. Let me be very brief, Mr. Chairman. I appreciate the chance to testify, and I want to compliment you for having the hearing. I do think it is appropriate that you are having this hearing at the very same time that the Armed Services Committee is having a hearing on the issue of whether we should be flagging Kuwaiti tankers to protect the oil lines to the Persian Gulf. I think that recent events in the Middle East have certainly brought home the importance of the issue of energy dependence, which is growing, I think.

Former Secretary Schleshinger made a very good point before the Energy Committee some weeks ago where he said we have a very clear policy in this country—people complain we have no energy policy—we have a very clear policy, and it is a policy of growing energy dependence. I thought that was a good way to put the problem. And I support, of course, and co-sponsor your bill, S. 255, to repeal the windfall profit tax.

It is clear that this is a very modest step in trying to deal with the problem. It merely would eliminate the very substantial costs that the industry presently has in trying to comply with the paperwork requirements imposed by that law. I think it is a piece of legislation that should be passed very speadily and I hope we can take some action on that this year.

Again, I appreciate the chance to testify. And I will defer to others. I fear that like in many hearings here we are preaching to the converted. Those of us who are here generally agree that something serious needs to be done in this area.

Thank you very much.

Senator BOREN. Thank you very much, Senator Bingaman. And it is our hope that through these hearings we will make a clear record of the need for change and it will put us in a position to present these proposals to our colleagues with background and information developed in these hearings so that we will be able to proceed forward with the actual enactment of legislation. And we appreciate your appearance here very much this morning.

I think your well stated comments about the appropriateness of this hearing at a time in which we are examining the very tenuous situation in the Middle East, the need for our own domestic energy security is very well taken. And I appreciate your comments very much.

[The prepared written statement of Senator Bingaman follows:]

TESTIMONY OF SENATOR JEFF BINGAMAN
Senate Finance Committee
Subcommittee on Energy Taxation
Legislative hearing on the Oil and Gas Industry
June 5, 1987

I thank the Chairman for inviting me to participate in this hearing and for his leadership in focusing the attention of the Congress and the American people on the growing crisis in our domestic oil and gas industry. As the Chairman knows, I have an abiding interest in the issue of foreign energy dependence and welcome the opportunity to share my views.

I am convinced our country is heading towards a real energy crisis. The crisis is inevitable, the only question is how soon it will arrive. We are moving quickly on a course that will lead to increasing vulnerability to unstable Middle Eastern sources of petroleum and inevitable higher prices for American consumers. Supply shortages could easily plague our economy once again as they did in the 1970's. Inflation could shoot up quickly again as oil prices rise. With the further depreciation of the U.S. dollar, you have a scenario for economic disaster.

The nation and our domestic oil and gas industry face an uncertain future -- uncertain because of lower prices, over-supply, and increased competition from low-priced imports of crude and petroleum products. The industry has been forced to cut back its activity -- signalling a loss of employment and a weakening of the industry's infrastructure. Capital expenditure programs have dropped by 50 percent since 1981. Drilling activity reached a 46 year low last August. High-cost U.S. producer and stripper wells are being squeezed out of the market by the lower oil prices. And new supplies of petroleum are no longer being discovered, either in the lower 48 or Alaska, at a rate consistent with current consumption levels.

I testified before this Committee in January and reported on the serious problems facing the state of New Mexico as a result of the decline of the oil and gas industry. Those problems still exist and have only grown worse. As I indicated, we clearly see the impact of heightened imports throughout the nation and especially in New Mexico: industry cutbacks, loss of employment, weakened industry infrastructure, reduced drilling activity, shut-in-stripper wells, and virtually no exploration. This nation currently imports approximately 40 percent of its domestic oil products, and the National Petroleum Council predicts that in the year 2000 the U.S. will import between 52 and 58 percent of its demand. In 1984, the gross cost of importing crude oil and refined petroleum products was more than $59 billion, an amount approximately equal to 50 percent of the U.S. trade deficit. The cost of imports in 1986 was $28 billion as a result of lower oil prices. However, the Department of Energy has predicted that by 1995, oil imports may cost the equivalent of $80 billion.

Secretary of the Interior Donald Hodel reiterated the seriousness of our growing reliance on imports earlier this week when testifying before this Committee on opening up the Arctic National Wildlife Refuge to oil and gas drilling. He acknowledged that America's growing reliance on imported oil could have potentially serious implications for our national security.

We must act to restrain our growing dependence on imports. Senator Boren's legislation offers us this opportunity. This Committee has already held hearings on imposing an oil import fee.

Today, the Committee is looking specifically at the repeal of the Windfall Profits Tax, and various incentive measures to rejuvenate the industry and spur domestic exploration and production. I can assure members of this Committee that the people of New Mexico support these initiatives. I chaired hearings in New Mexico this spring on the status of the domestic industry. I heard testimony from government officials, business and civic leaders, and local citizens in complete support of what we are considering today.

Windfall Profits Tax

The Windfall Profits Tax, while not being collected currently because of low oil prices, still costs the industry hundreds of thousands of dollars every year because of the mountain of paperwork needed to inform the government that there were no profits. The tax has done nothing to help us combat rising imports. It is only a tax on domestic producers. It is not a tax on imports. And these imports have displaced domestic production and contributed to our negative balance of payments and the negative balance of trade we are currently experiencing in this country. I think it is imperative that we consider seriously any worthwhile economic incentives that can stimulate exploration and production. Senator Boren's legislation embodies such incentives.

Repeal "Transfer" Rule

Current law says that when an independent producer buys "proven" producing property from an integrated major, that property is not eligible for Windfall Profit Tax exemption or percentage depletion. Repeal of the transfer rule would allow independents to benefit from percentage depletion and any WPT exemption that may exist. This would benefit both the integrated companies by encouraging them to sell uneconomic properties, rather than abandoning them, and generate additional incentive to independents to purchase and to continue to produce these properties.

Repeal of the 50 Percent of Net Income Limitation

Current law says that the percentage depletion deduction is limited to not more than 50 percent of the net income of an eligible producing property. Repeal of this section would stimulate additional cash flow to those producers who still have income-producing properties.

I am also extremely interested in the idea of a drilling credit to encourage increased domestic resources. I look forward to reviewing the testimony of today's witnesses on all incentive proposals.

Conclusion

I hope this and future hearings of the Finance Committee and the Energy and Natural Resources Committee on which I sit, will further educate the American public and this Administration to the serious implications for the economic well-being and national security of the nation if the current crisis in our domestic oil and gas industry is allowed to continue. My view is that a strong, profitable domestic oil and gas industry is vital to this nation. The strategic interests of our country are clearly at risk. From these hearings, we must build a consensus for an effective and comprehensive national energy strategy.

I look forward to reviewing the testimony of the panelists today to see what recommendations they have to help build a comprehensive response to the crisis our domestic industry is now faces.

The **Chairman**. If I might comment, Mr. Chairman. When Senator Bingaman says he is preaching to the choir and to the converted, that is true. But I must say that I am hearing more and more from members from non-energy producing States about their increasing concern about our dependence on a politically unstable area for the oil that comes into this country, the increasing amount of oil that we are dependent on, and what we can do to find some way to try to turn that around. It is not going to be easy. Politically, it is going to be extremely difficult.

It is going to be important too that we have a President that supports it. That will make it easier to accomplish.

Up to now, I think what has been proposed by the Administration falls far short. Although I would agree with my colleague from Texas and the chairman here that we all support those particular measures, we must try to find additional means to really encourage oil and gas exploration in this country and cut back on our dependence on foreign oil and gas.

Senator **Boren**. Thank you very much.

Senator Domenici.

STATEMENT OF HON. PETE DOMENICI, U.S. SENATOR FROM THE STATE OF NEW MEXICO

Senator **Domenici**. Mr. Chairman, and Chairman Bentsen, let me concur with my friend from New Mexico. I will be brief, but I would like to just dramatize the dilemma we are in.

This is a very simple but accurate chart, Mr. Chairman. The black line is price; the red line, as indicated there, is exploration and development. The lines reflect dollars and billions of barrels. And if that isn't the case in a nutshell, I don't know how we can say it better.

Now what are we going to do? At one point we were here on this black line, and here is the amount of money being invested in domestic development. We are now here, and believe it or not, the Congress of the United States still has a windfall profit tax on that might go into effect about here, and 70 percent of every dollar, once it reaches that point, instead of going into exploration and in development, it will go to the United States Treasury.

I mean, the whole purpose of this hearing, which I compliment you enormously for, is to indicate that we are growing in dependence because our production is being tremendously adversely affected by price and, consequently, it has almost dropped off the table.

Why in the world, if that was the case, would we be sitting by waiting for an event—and I agree with the junior Senator from Texas that it may be within one year—that a substantial portion of tier 1 oil will begin to be taxed under windfall, meaning instead of that 70 percent that they are going to take going into development, it will go into the United States government's pocket.

If there is anything that is absolutely stupid, counterproductive and borders on lunacy it is that.

The other part of the hearing obviously has to do with the very, very essence of this chart. What can we do by way of incentives that pushes this exploration and development line up? And that is the essence of all of the proposals. And in order to do it, one of two things has to happen. The price of oil has to go up, or you have to give those who are going to invest more of an incentive for doing it.

So I compliment you for what you are doing here today. I think we no longer have the luxury of time.

Last year when we dealt with windfall profits it was sort of way off in the past. It is here now. Aside from its 100 million dollar cost for paperwork, 15 or 20 unresolved major issues with the IRS, where they still do not know how to apply windfall profit tax—the stripper wells, imputed strippers, certain hydrocarbons—it is still being worked on by IRS and industry. We have all of that, and we are wondering whether we ought to repeal this law.

It seems to me, Mr. Chairman, that some might say Senator Domenici has a parochial interest. Indeed I do. My industry has been cut in half. The number of employees are half of what they were. The revenue to my State has been cut by one-third. It used to be 34 percent of our general fund. It is 11. So I do have a parochial interest. But it just happens that my parochial interest is quickly becoming synomymous with the interest of all the people of this Nation, because if we don't do something about it we are going to have a major economic disaster in this country. We may never be able to solve the dependency issue. It is complex. We have always been dependent. We consume more than we could ever produce and that is why we are such a giant economic machine.

At one point we were accused of using 33 percent of the world's energy. What they forgot to say is that it is pretty logical. We produced 36 percent of the world's goods and materials at that point in time. A pretty good tradeoff.

So we are not hogs. We are just trying to keep our economic machine going and energy is at the heart of it, in particular, crude oil and natural gas for the foreseeable future.

We will help you. We hope you report out a bill and we hope you go beyond the President's recommendations. They are good but they are not enough. Thank you very much.

Senator **Boren**. Thank you very much, Senator Domenici. And I share that hope and your concluding statements. Let me also say that if some of the proposals which you developed earlier—and I was privileged, and I know Senator Bentsen, and Senator Nickles and others were privileged to work with you as well—in terms of a poor price and other kinds of proposals that would stabilize the domestic industry, we would not have had the catastrophic decline that we are now experiencing. And I hope that the chart which you presented to us today will be taken to heart because I cannot think of any more graphic way of demonstrating what is happening to us, and the direct relationship between the economic incentives that are necessary and what is happening to the level of domestic production. And I appreciate you sharing those thoughts with us.

Senator **Domenici**. Well let me say to both of you, the chairman of the full committee, and you, Mr. Chairman, I appreciate your efforts last year. Together, we tried to put on some modest import fee. That would have been tremendously helpful, in my opinion. We are still attempting to do that.

I compliment Senator Bentsen in the trade bill for his efforts to address the 50 percent level of dependence and do something about it through executive activity when we reach it.

I don't know where all those things will go, but sooner or later, some majority in the Congress is going to find out that we need more production, and that there is indeed a tradeoff, an economic tradeoff, and that if we can just find it, it inures to the benefit of the American people. Taken in isolation, obviously it does not. But when you take it in terms of the consequences of not doing it, there is a balancing point when it is both economic, prudent and any other word you could attach. We don't seem to be able to convince people of that yet. I only hope we don't need the lines again. I hope we don't need people waiting for hours in the morning and then shooting each other in New York because they argue over what place they should have in the waiting line. And inflation going through the roof, and industries who were operating under curtailment. I tell you, that could happen again. If anybody thinks strategic petroleum reserve alone will prevent that, they really are dreaming, in my opinion.

The CHAIRMAN. Senator, let me ask you a question about those lines.

Senator DOMENICI. Yes, sir.

The CHAIRMAN. Identify those two lines for me again, please.

Senator DOMENICI. Yes, sir. Mr. Chairman, the black line is price, and down here we are following the price of crude oil, and as it goes up and as it comes down. And the red line is exploration and development outlays in the United States. Where did they put the money. And there goes the line. And as you can see, when it reached its peak right around 30, the investment was enormous.

The CHAIRMAN. I think that is dramatic and illustrative of your point. I would add one more line.

Senator DOMENICI. Yes.

The CHAIRMAN. Cost of production.

Senator DOMENICI. I think that is true.

The CHAIRMAN. And I would put that line right there and then let them tell me that we have some windfall profits in that industry. We do not.

Senator DOMENICI. I think we ought to do that.

The CHAIRMAN. Now what you have to show is what has happened to costs over the long term; they have escalated enormously. Our costs of production are on the rise as we have to drill deeper wells and go further afield to find new reserves. That is why the windfall profit tax just does not make much sense. Conditions have so dramatically changed since the time when the windfall profits tax was enacted. I fought against the tax then because I thought it was a bad idea. Now it has been proven a bad idea, and the time has come to repeal it. I am going to do everything I can to try to bring that about.

I have enjoyed working with you, Senator, on this issue. You add a lot of credibility to the issue with your thoughtfulness and the research that you have done. Thank you.

Senator DOMENICI. Mr. Chairman, let me say I did have in my notes, and I have forgotten. I think you are absolutely right to mention that another thing that makes the windfall profit tax at its current level kind of ridiculous is that we have not adjusted it to the cost of production and development. There is just no question about it. And thank you very much.

Senator **Boren**. Thank you very much, Senator Domenici. Senator Daschle, another member of the subcommittee, has joined us and we are very glad to have you with us this morning, Senator Daschle.

I am glad to have as our next witness my colleague from Oklahoma who has worked tirelessly to try to do something about this problem, not only on the Senate floor where he successfully presented a bill last year that had it gone all the way through the process would have repealed the windfall profit tax, but also is a very active and able member of the Energy Committee as well. Senator Nickles, we are very glad to have you with us this morning.

[The prepared written statement of Senator Domenici follows:]

Statement of Senator Pete V. Domenici

Subcommittee on Energy and Agricultural Taxation

June 5, 1987

Mr Chairman, I appreciate this opportunity to testify before the Subcommittee on an issue that is clearly one of the most important facing this nation, the issue of our enery future.

There are few ways that anyone could overemphasize the importance of this concern. Just in recent days, the incident of the USS Stark underscores the serious threats to our national energy, military, and economic security caused by our ever-growing dependence on imported oil.

In 1985, when U.S. imports met 27 per cent of our need, a diversified mix of countries supplied that oil.

As our dependence has grown from 27 per cent to a startling 40 per cent today, that additional increment of oil has come almost exclusively from the Persian Gulf. This is true because other major producers --- Canada, Mexico, Argentina, the North Sea countries --- have edged close to full capacity production.

Therefore, if our dependence increases beyond 50 per cent, the only place that "new oil" can come from is the Persian Gulf. This is very frightening.

One issue before you today is whether to repeal the Windfall Profits tax. Since it only taxes U.S. production, that tax has the practical effect of subsidizing oil imports. Isn't that tax doing exactly what we don't want to do?

Given the trade deficit we are running, this is bad policy. It also tends to move investment off-shore because Windfall Profits Tax is viewed as an additional cost of production for U.S. resources. Even without the security risks that are so obvious in any dependence upon Persian Gulf crude, we shouldn't be encouraging foreign production at the expense of domestic production.

The Senate voted to repeal The Windfall Profits Tax. It was the first bill I co-sponsored this year.

The Windfall profits tax was a bad idea when it was enacted. In the short run, the tax reduces domestic production by increasing the cost of producing oil. In the long run, the tax reduces the rate of return to oil production and capital is reinvested in industries other than oil.

These distortions are inconsistent with the tax reform effort we undertook last year. The marketplace should allocate capital, not the tax code.

I have been working with Secretary Baker and Commissioner Gibbs to solve some trouble spots in the Windfall Profits Tax.

Seven years after the Windfall Profits Tax became law, the Congress, Internal Revenue Service, and industry still haven't been able to agree on how to define stripper oil in a manner consistent with Congressional intent. They have failed to resolve the appropriate tax treatment on stripper oil and the definition of "imputed stripper."

Mr. Chairman, we continue to struggle with the proper Windfall Profits Tax treatment of certain liquid hydrocarbons. I have mentioned three examples; there are countless others. From a technical standpoint, this law is more trouble than it is worth.

I receive letters every day from taxpayers complaining about inconsistent tax treatment, unresolved questions regarding the law--confusion and frustration--all this, when no tax dollars are involved!

Given the depressed price of oil today, if the prices move up much more, the tax would again be triggered, with 2,500,000 barrels per day of U.S. production --- of 44.6 per cent of total U.S. production --- would come under the tax.

If the Windfall Profits Tax is triggered, 70 per cent of any price increase would fo to the Federal Governemnet in the tax.

Increased oil prices should be a blessing because the industry needs to get back into the exploration and development business. But as long as Windfall Profits Tax is lurking, those badly needed dollars for exploration and development end up at the Federal Treasury, instead of exploring for new oil fields.

The relationship between profits and exploration and development budgets is easily documented. If we repeal the tax, we will see more greatly needed exploration.

Given our current trade deficit and our increasing dependence on foreign oil, the logical thing to do, it seems to me, is to repeal the Windfall profits tax --- and repeal it now --- then impose a $5 a barrel oil import fee.

The Windfall Profits Tax was a tax designed for another era. It is out of date and damaging to America's best interests.

I commend the Administration on their tax initiatives. Many of the suggestions are familiar as a group of us have been meeting with Secretary Baker for the past two years on these initiatives, marginal production tax credits; repealing the net income limitation rule and allowing transferred property to qualify for percentage depletion; increasing the depletion allowance from 15 to 27 percent; treating geological and geophysical costs as expensible, all tax measures that would be of help.

The problem is that even if they were all passed, which isn't likely, they still would not prove adequate.

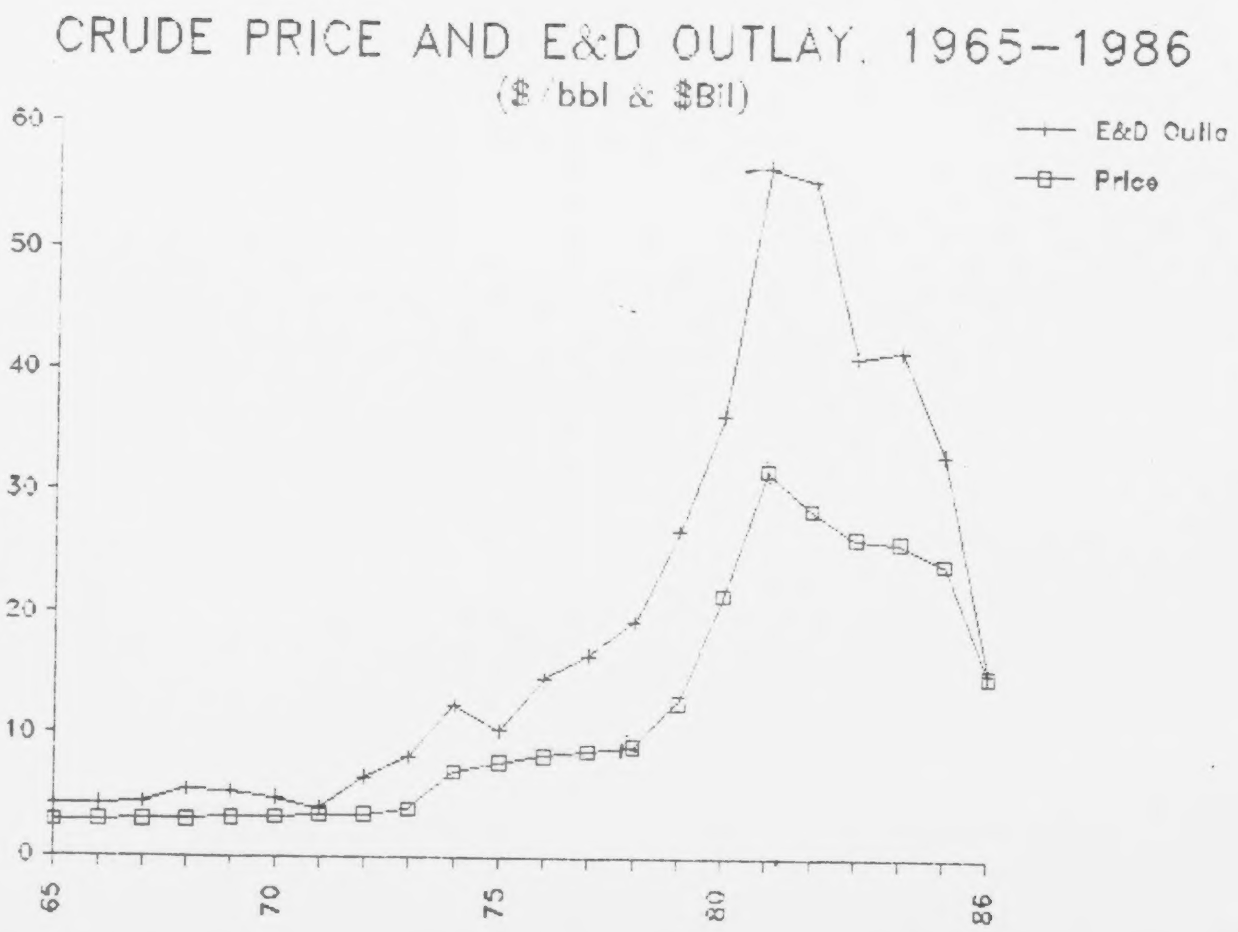
We need an oil import fee.

In 1982, there were 17,000 people in the oil and gas industry in my state. Today it is closer to 9,000. In 1982 oil and gas taxes accounted for 34.4 per cent of the state's general fund. Today it is closer to 11 per cent.

The impact on my state and the country is substantial. The implications of the six-year war in the Persian Gulf should be a warning to us all to take corrective, and timily, action.

In conclusion, Mr. Chairman, we need to repeal the Windfall Profits Tax and impose a realistic and effective oil import tax.

Let's get America out from under the increasing dangers of our dependence on imported, Persian Gulf oil. Thank you.


CRUDE PRICE AND E&D OUTLAY, 1965–1986
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E&D Outla
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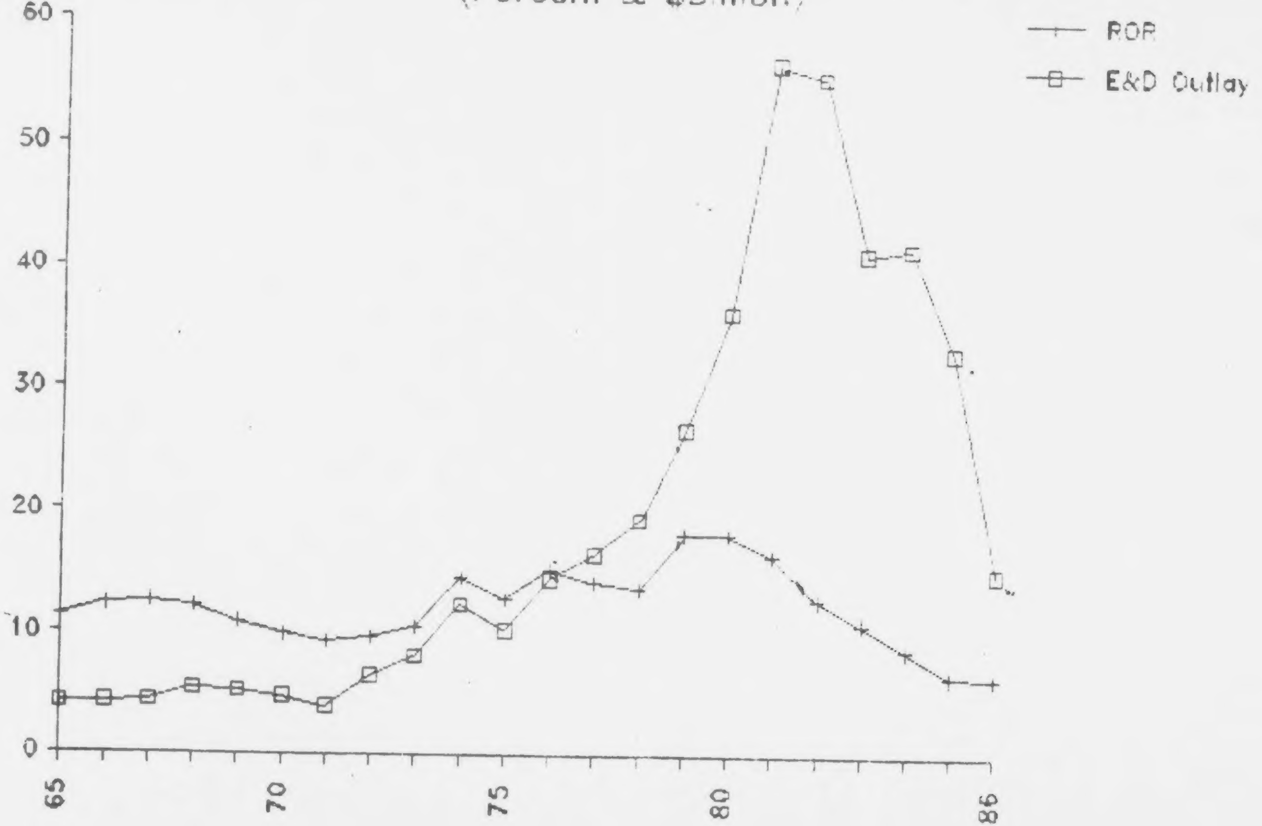
RATE OF RETURN AND E&D OUTLAY, 1965–86

(Percent & $Billion)



STATEMENT OF HON. DON NICKLES, U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator NICKLES. Mr. Chairman, thank you very much. And Senator Bentsen and Senator Daschle, it is a pleasure to join you and my other colleagues.

Senator Bentsen, let me make just a comment. I appreciate your opening comment and the fact that you went back and talked about the economic consequence in costs to the entire country of the shortages that we experienced both in 1973 and 1979.

You mentioned that you felt like that awareness was becoming more widespread through the Congress and through the country. I am not sure that is the case. We had a hearing before the Energy Committee earlier this week on your proposal.

The CHAIRMAN. With some notable exceptions, Senator.

Senator NICKLES. And I just thought I would mention that there is I think a real lack of understanding or awareness of the gravity of the problem. And I know you have Secretary Martin coming before, and I compliment them on their study. Although I have told them and I will tell you, I think their study underestimated the problem.

My guess is that we are going to be looking at importing 50 percent by the year 1990, two and a half years from now. I may be wrong; we will find out. I estimate that we will probably be importing around 60 percent by the year 1995, and I estimate that we will be importing probably two-thirds by the turn of the century. That is just 12 and a half years from now.

When you look at the fact that we had curtailments when we were importing 33, 34 percent in 1973, and 44 percent in 1979, and we are talking about importing—gross imports—we are looking at 55, 60, 65 percent plus in the next five, eight years. I think that helps put it in prospective.

We are going to be very, very dependent on unreliable foreign sources. And I do not think that has really soaked in yet to most of our colleagues and to the American public. And certainly the economic consequences if those short-falls do take place.

So I compliment the members of this committee and my colleagues on the Energy Committee that are trying to wake up America so we can do something about it. Actions can be taken, actions should be taken to alleviate this problem. The actions have to be taken now if we are going to have any real impact on reducing the problem in the out years.

The legislation Senator Boren has discussed is very commendable. I would agree with my colleagues that the Administration's proposals are steps in the right direction but they are small steps. Certainly we need to repeal the windfall profit tax. That tax raised $77.8 billion since its passage. And as Senator Bentsen said, there is no windfall profits.

I commend you on the panelists who will be making their statements today. They are outstanding. Those industries are not making windfall profits.

Mr. Chairman, as you are well aware of, we talk about the inequity, and we talk about a trade bill that will be coming up, and we talk about trying to give American industries some balance, some competitive, possibly equality, with our competitors, the windfall profits tax raised $77.8 billion on domestic producers. It raised zero on imports. And so we gave imports a competitive advantage. And if you wanted to compute that on a per barrel basis, on the first five years of windfall profit tax, it was about $5.00 per barrel that we taxed domestic producers more than we taxed imports. So we encourage the imports and we discourage domestic production. That is absurd.

And it is still on the books. Yes, we repealed it in the Senate but the House did not do it last year, so it is still on the books. And somebody says, well, will it trigger this year? We trigger windfall profit tax on tier 1 at $18.97. That was on second quarter of 1987. We triggered tier 2 on $22.51, and we triggered tier 3 newly discovered oil at $28.44. I think there is a good likelihood that we will trigger tier 1 and possibly trigger tier 2 in the next couple years. I hope we do. But certainly we need to get rid of the windfall profit tax.

Wouldn't it be absurd, and the fact that you have domestic producers, independents going out of business, and if we cross that threshold we get about $18.97, we get $21.00 oil, or $22.00 or $23.00 oil. If Uncle Sam comes in and takes 70 percent of those incremental increases or 50 percent in the case of the independents, that is totally completely absurd. It needs to be repealed. We need to take this competitive disadvantage away that we have placed on the domestic industry that we do not have on imports. It is just absurd. It needs to be repealed. It needs to be repealed as early as possible.

And, Senator Boren, your statement on administrative costs being in the millions of dollars, it is in the millions of dollars just to the Department of Treasury. It is not counting the millions and millions of dollars that it is on the industry itself, on majors, and on independents, on royalty owners. So it needs to be repealed. And again, that is the bare minimum. And it needs to be done this year.

And for my colleagues' information, I am very interested in seeing that happen as early as possible. Whether that be on the debt limit extension, on the trade bill, on the reconciliation bill, we are looking at the nearest vehicle--the best available vehicle—and I will work with you to coordinate our efforts. I want our efforts to be successful. They need to be successful. But we need more than just repeal the windfall profits tax. We need a host of other items.

One other item I think I have heard, expensing of G and G. But certainly I would agree repeal the restrictions on transfer. Certainly that is needed. I would say the bare minimum as well, we need to exclude intangible drilling costs from the ultimate minimum tax. It is really absurd to have an out-of-pocket, non-recoverable business expense included as a preference item so you can have additional surcharge on those expensed items.

I know the Senator from Texas has business experience, and the Senator from South Dakota and this Senator as well. You expense non-recoverable out of pocket expenses. You do not have a tax surcharge on them. And that is exactly what we have right now in having intangible drilling costs included as a preference item for the ultimate minimum tax.

And so I hope as a bare minimum that would be one of the other things that we can get.

The Senator has also mentioned a variety of other things, including some tax credits, et cetera. We need to wake up. If America does not wake up, we will be doing exactly what I forecast, and that is a very sober projection, to say that you are going to be importing 60 percent, or two-thirds, by the next 12 years. If that happens—and I am afraid that it will happen—we are going to find our country very susceptible to the types of curtailments Senator Bentsen mentioned and the cost to our economy throughout the country, not just the producing States but the cost throughout the country and economy worldwide could be catastrophic.

Thank you very much for the hearing.

Senator BOREN. Thank you very much, Senator Nickles, for those comments and for the information which you provided.

I want to enter in the record at this point a copy of a form 6248. Millions of these are being filed. There is a penalty for, a collective penalty, of up to a maximum of $100,000 for failure to file these forms. Most of these forms, as I say, by the millions, report absolutely no taxable income. The IRS could, through issuance of regulation or information, state the form 6248 is not required when it provides information that is of no benefit. That has not been done as yet. And I will enter copies of those forms into the record as an example of the needless paperwork that is being undertaken.

Senator NICKLES. Would you enter my statement in the record?

Senator BOREN. We will receive your full statement into the record, without objection. Thank you for appearing this morning.

Senator NICKLES. Thank you.

Senator BOREN. Our next panel will consist of Mr. William Martin, the Deputy Secretary, Department of Energy, and also Mr. Don Chapoton, the Deputy Assistant Secretary for Tax Policy, Department of the Treasury. And in order that we can keep our schedule of witnesses on time this morning, I might ask that our witnesses summarize their testimony and try to hold them to at least within a 10-minute time frame.

Mr. Martin, we are very glad to have you here with us this morning and you may proceed.

[The prepared written statement of Senator Nickles follows:]

STATEMENT OF SENATOR DON NICKLES
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

HEARING ON PROPOSALS TO REPEAL THE WINDFALL PROFIT TAX AND TO INCREASE U.S. OIL RESERVES

JUNE 5, 1987

Mr. Chairman:

I want to thank you for holding this hearing to receive testimony on the need to repeal the windfall profit tax and on other tax changes that will increase U.S. oil reserves.

Earlier this week, the Senate Subcommittee on Energy Regulation and Conservation held an oversight hearing on S. 694, the Finance Committee Chairman's Energy Security Act of 1987. It was clear from that hearing, Mr. Chairman, that the rapidly growing amount of oil imports is a very serious national security and economic welfare matter.

The Department of Energy's recent Report on Energy Security projected that the U.S. level of foreign oil dependency could rise to 45 percent by 1990 and 57 percent by 1995. As I again brought to DOE's attention at the hearing, I expect that the United States will be 50 percent dependent on imports by 1990 and 60 percent by 1995.

Clearly, if these projections are realized, the United States will be seriously vulnerable to a major oil supply interruption. As you recall, just prior to the 1973 Arab oil embargo, the United States was only dependent on foreign oil for one-third of its net petroleum needs.

The recent attack on the U.S.S. Stark brings into focus the dangers of a national policy that ignores our growing dependency on oil supplies from the Middle East. In 1986 we imported more than twice as much oil from Arab OPEC countries as we did in 1985. It will not help solve our import dependency problems by increasing U.S. imports only from "friendly" and "stable" trading partners such as Great Britain, Canada, Mexico and Venezuela. Oil is a world-wide commodity, each country dependent on the other for supply and price. What happens to oil production in Iran effects the oil industry in the United States and every other producing and consuming nation.

What does all this have to do with the windfall profits tax? Plenty. This tax has been and continues to be an impediment to domestic oil production. Between 1980 and 1985, domestic oil producers paid about $77 billion in windfall profit taxes. And now that windfall profit taxes are not being paid because of the low price of oil, millions of dollars are spent every year in complying with federal paperwork requirements--even though NO tax is being paid.

No other industry is saddled with a so-called windfall profit tax which was designed simply to take away revenue earned by the energy industry. It may be good politics to bash big oil in some states, but it makes bad policy. Who suffers for this lack of Congressional foresight? Consumers.

At a time when we are increasing our dependency on foreign oil, we should be doing everything possible to ensure that we don't put our domestic industry out of business. We need to repeal unreasonable regulatory restraints, like we did the Fuel Use Act only a few weeks ago. That action is going to help consumers. And repealing the windfall profit tax makes sound domestic energy policy as well.

The Administration's proposals in response to its own Energy Security Report are not enough. Its proposal to decontrol natural gas has been debated in this body for six years, and opening the Alaska National Wildlife Refuge to oil production will not bring about increased domestic production for many years.

The Administration did recommend three tax proposals, which could help. These tax changes would repeal the Windfall Profit Tax, increase the Net Income Limitation to 100 percent per property, and repeal the transfer rule with respect to percentage depletion.

I have included the Administration's energy tax changes in my bill, S. 846, the Energy Security Tax Act of 1987. The Energy Security Tax Act also contains several additional provisions that I look forward to having the witnesses comment on today. Those additional provisions include: repealing the taxable income limitation on percentage depletion; excluding intangible drilling costs for the alternative minimum tax; providing percentage depletion for new, enhanced and stripper production; including geological and geophysical costs as IDC's; repealing the taxable income limitation on percentage depletion; and clarification of the statute of limitations with respect to underpayments of the windfall profit tax.

Again, Mr. Chairman, thank you for holding this hearing to focus the debate on the legislative proposals that are critical to maintaining a viable domestic oil industry.

STATEMENT OF WILLIAM MARTIN, DEPUTY SECRETARY, DEPARTMENT OF ENERGY, WASHINGTON, DC, ACCOMPANIED BY SCOTT CAMPBELL, HEAD OF POLICY, DEPARTMENT OF ENERGY

Mr. MARTIN. Thank you, Mr. Chairman, and thank you for having this hearing. We think it is a very timely moment.

Just last week the President said that he is determined that our national economy will never again be a captive; that we will not return to the days of gas lines, shortage, inflation, economic dislocation and international humiliation. And yet we know from our very own report that imports are on the rise. Eight to 10 million barrels a day by 1995, well over 50 percent, and possibly close to Senator Nickles 1960 percent by 1995. That is what the Administration is saying if indeed imports remain low.

More importantly, worldwide dependence is on the rise in Europe, and Japan and third-world nations. All nations are going back to the trough of the Persian Gulf. The bottom line here is that OPEC could have as much as 60 percent of the market by 1995 and most of that coming from the volatile Middle East. So there we are. We have defined the problem well. And now I appreciate the opportunity to work with you and the Energy Committee as well on solutions which we know are a lot tougher than finding problems.

I would like to address, first, the windfall profit tax. Let's ask ourselves five questions. What windfall? What profit? How much tax? Is it fair? And who is hurting ultimately?

Well, first, let me just put up a chart about what windfall. We know that when this was debated in the late 1970s many of us felt the price was going to go up to 30, to 40, to 50, to 60 dollars, and based on that premise, it was believed that there was enough for everybody. The government can benefit and industry can benefit. But, of course, that did not happen. In fact, the price went down, way down, last year. And so what windfall? There is none.

Let's talk about profit.

The second chart talks about how much it cost to produce a barrel of oil in the United States today. And as you can see, the average finding cost has been going up, and the afterage lifting cost has been going up. And, roughly, the average price to bring a barrel to market today is $18.50. Well we look at what the price today is in cushing for West Texas intermediate and we see it is $18.50. So what profit do we have? Very scampy.

Now let's talk about how much tax. Well indeed we have heard that this tax has provided about $77 billion. Industry should be congratulated for providing that amount. But right now we do not collect any. We have a lot of needless paperwork. And, quite frankly, we are imposing it on an industry which is in the worst shape it has been since after the depression and before World War II.

So we have to ask ourselves, is this tax fair? Well, no, it is not fair either because we do not do it for any other industry. We do not ask any other industry to provide 70 percent of its profits to the Treasury. So it really goes against the principles and the heart and soul of tax reform.

Now, ultimately, who does the tax hurt? Well it has been so eloquently stated here by many Senators. It hurts everybody. Because unless we have a viable oil and gas industry in this country, it is going to be the consumers that lose out in the long term.

Well let me just conclude on windfall profits. If there has ever been a time to repeal it, it is now. And we want to work very closely with you, Mr. Chairman, to get this needless tax off the books.

The President has also proposed a couple other technical amendments to tax reform. One is repealing the transfer rule, another is increasing the net income limitation. We think that these will help reduce early abandonment of wells, particularly stripper wells, which are 15 percent of production in this nation. And indeed we think that these changes would avoid opening up basic issues of tax reform that we worked so hard for last year.

Let me conclude, Mr. Chairman, by saying that it was just about a year ago that this committee—Senator Bentsen, and yourself, and others—worked together with the Administration to retain depletion allowance for independents and expensing of intangible. And we think that was a major victory. And to this day we believe that saves something like 700,000 barrels a day of production for this country. Absolutely critical. And we want to do more. The President has outlined what he would like to do and we want to work with you.

Let me say, in conclusion, Mr. Chairman, I brought Mr. Scott Campbell, who is the head of DOE policy, here, who contributed a major amount to the Energy Security Report, as well as Don Chapoton. I have got two Texans and an Oklahoman here. So we look forward to answering any questions you might have.

Senator BOREN. Thank you very much, Mr. Martin. I believe we will go on to Mr. Chapoton and then we will entertain questions to the entire panel. Let me say that we have also been joined by Senator Matsunaga, from Hawaii. And he is a Senator from a State which is not an oil and gas producing State. He has been very sensitive to the need for energy security for our country, and has taken the lead, cast votes and taken the lead on several key pieces of legislation that have made the difference in helping us to preserve some of the incentives that have just been discussed. He is very knowledgeable in this area and we appreciate his interest.

Mr. Chapoton.

[The prepared written statement of Mr. Martin follows:]

Testimony of

William F. Martin

Deputy Secretary of Energy

before the

Subcommittee on Energy and Agricultural Taxation

Committee on Finance

United States Senate

June 5, 1987

OPENING REMARKS

Mr. Chairman, Members of the Committee. Thank you for the opportunity to appear before you today to present the views of the Department of Energy on the merits of repealing the Windfall Profit Tax and making other technical changes to the tax code to increase energy security.

The Administration is concerned about the energy security implications of lower oil prices and the health of the domestic oil and gas industry. This concern was strongly evidenced during the development of tax reform legislation last year. The Administration fought hard for and succeeded together with Congress in retaining the expensing of Intangible Drilling Costs and the use of percentage depletion by independents. These two tax provisions were estimated to save about 700,000 barrels per day of U.S. oil and gas production that might otherwise have been lost. Still more needs to be done.

NEED FOR WINDFALL PROFIT TAX REPEAL

One of our highest remaining priorities in the tax area is removal of the Windfall Profit Tax. If there was ever a time to remove this tax it is now while the domestic industry is battling for its survival.

The year 1986 was a period of unequaled difficulty for the domestic oil and gas industry. In 1986, crude oil prices fell by nearly 50 percent. The price collapse sent shockwaves through the domestic oil and gas industry resulting in substantial reductions in capital spending, the loss of 300,000 jobs, and deep setbacks in oil and gas exploration.

The number of wells drilled in the United States fell by more than 50 percent to pre-World War II levels, and the number of seismic crews searching for oil dropped by more than one-half to levels not seen since 1934. U.S. oil production fell by 800,000 barrels per day in 1986 back to 1981 levels. As a result, U.S. imports of foreign oil have increased by one million barrels per day. If present trends in the United States and elsewhere continue, the world will become increasingly dependent upon insecure sources of oil.

WHY THE ADMINISTRATION SUPPORTS WPT REPEAL

The Administration supports repeal of the Windfall Profit Tax (WPT) because the tax is inconsistent with the fairness objective of tax reform legislation and because the tax extracts a high energy security cost. The energy security cost occurs because the tax discourages U.S. oil and gas exploration and production contributing to rising oil imports.

The tax discourages production for three reasons. First, if oil prices rise above $19 per barrel, the tax will have a major and immediate negative impact on what tends to be our most cost-effective development drilling. Specifically, 70% of any increase in price over $19 per barrel on about 2.5 million barrels per day of U.S. production will be diverted away from potential reinvestment in cost-effective reserve additions. Second, the tax discourages investment in U.S. oil and gas exploration and thereby reduces U.S. competitiveness compared with similar investments overseas. Third, the tax encourages premature abandonment of marginal wells because of transfer of property rules between majors and independents. In addition to the energy security concerns raised by this tax, the compliance costs and the paperwork burdens are expensive for both government and industry.

The WPT was enacted at a time when oil prices had increased rapidly to $35 or more per barrel. The conventional wisdom at the time was that oil prices would continue to rise rapidly. There were serious fears that prices were going to $50 or $80 per barrel. Some argued that by decontrolling oil prices, a so-called "windfall" would be given to domestic oil producers for oil discovered prior to price decontrol. They argued that with oil prices of over $35 per barrel and finding and development costs about $15 per barrel, there was an adequate incentive for investment in domestic drilling activity and plenty of "room" for such a tax. The tax was enacted, and the domestic oil industry paid a net total of about $50 billion in "windfall profits" through 1986.

The rationale for this tax quickly faded. Rather than rising to ever higher levels, oil prices began to decline in 1981 and in mid-1986 collapsed below $10 per barrel. Oil prices today are about $18 to $19 per barrel. U.S. finding and lifting costs, together with royalty fees, other production taxes and overhead costs, are over $18 per barrel. This means that most domestic oil producers have little, if any, profits and are not investing in new drilling activity to replace depleting domestic oil reserves. The consequences for the Nation are painfully obvious -- falling production and rising imports.

Now, as oil producers are struggling to recover from a severe market reversal, it is unfair and unwise to continue to single them out and burden them with a special tax -- a tax applicable only to this industry. One of the goals of tax reform legislation was to eliminate special tax provisions. Retention of the WPT simply cannot be justified as part of a neutral tax structure.

TECHNICAL CHANGES TO THE TAX CODE

There are two other tax provisions that can no longer be justified. Modifying these provisions could help reduce early well abandonment and stimulate additional oil and gas drilling activity without opening basic issues in tax reform legislation. The required technical modifications would remove restrictions on the use of percentage depletion by independents. One change involves repealing the "transfer" rule which prevents independents from applying percentage depletion to purchased properties. The other modification involves raising the net income limitation which can limit the amount of percentage depletion claimed by independents on individual properties.

Barring the use of percentage depletion on properties sold by major producers to independents (the "transfer" rule) has the unintended effect of causing premature abandonment of some marginally profitable properties owned by the majors.

Many stripper wells are capped each year as their production declines to unprofitable levels. Some wells that would be abandoned under the cost structures of major producers can be profitably operated by independent producers with their generally lower overhead. Allowing the use of percentage depletion in the case of transfers from the majors will keep some of these wells in operation. Although production from each of these wells is small, stripper wells contribute over 1 million barrels per day to U.S. oil production. We lost as many as 90,000 stripper wells in 1986; we cannot afford to continue losing such wells.

The income limitation presently applicable to use of percentage depletion claims by independent oil producers limits those claims to 50 percent of the net income from a particular property. The net income limitation was originally put in place to limit the use of oil and gas depletion to shelter other income from taxation. Tax reform legislation has limited tax shelter opportunities and reduced abuses; therefore, the net income limitation is no longer justified. Increasing the net income limitation to 100% would be consistent with the objectives of this tax reform provision.

Also, when oil prices have been low, as in the past year, the income test severely limits the use of percentage depletion. Raising the limit to 100 percent of income would permit producers to make full use of percentage depletion allowances against taxable income. This change would improve the after-tax cash flow of struggling oil producers. In many cases, the added cash flow would permit domestic producers to pay their debts, retain their employees, or resume exploration and production as prices edge back toward $20 per barrel. Independent producers constitute a vital part of the domestic oil and gas industry. Their survival will be needed by the Nation as U.S. production continues to fall.

CONCLUDING REMARKS

The domestic oil industry paid its dues through Windfall Profit Tax payments of about $50 billion between 1981 and 1986. Now the industry needs relief from unjustified and discriminatory taxes such as the Windfall Profit Tax and other technical tax restrictions that limit the ability of independents to apply percentage depletion.

The Administration strongly supports the enactment of legislation to repeal this unjust tax and would ask Congress to consider making necessary technical adjustments to the tax code to improve the competitiveness of domestic oil compared with oil imported from foreign sources. The Administration cannot support the additional tax incentives as contained in S.846 and S.233.

Thank you. This concludes my formal presentation. I would be pleased to answer questions.

STATEMENT OF O. DONALDSON CHAPOTON, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. Thank you very much, Mr. Chairman.

I would introduce my complete remarks in the record, but in light of what has been said so far, I would like to keep my comments very limited and directed to the tax proposals before us.

Getting into the tax proposals though I might just comment that, in considering the various energy security problems in the Department of Energy study, and then when the President considered these problems that were obviously present be reason of the lower oil prices, the President's statement was a balanced consideration, a consideration of what should be done in light of these dire circumstances, in light of fiscal restraints, and in light of the recently enacted tax reform.

He proposed, as we all know now, a number of non-tax as well as tax items. The specific non-tax items included deregulation of natural gas, opening the national wildlife refuge, reducing the minimum bid requirement for offshore drilling. Those matters would all have a significant positive impact on our petroleum reserves and our petroleum situation.

In addition, as has been said, there were three tax items included: the repeal of the windfall profit tax; the repeal of the transfer rule; and the increase of the net income limitation.

I think a lot has been said this morning about the windfall profit tax and the need to repeal it. And I think we agree with all that has been said. I think it just can simply be said that any windfall to producers which resulted from the deregulation of domestic crude oil has already been taxed. If domestic crude oil prices rise now and producers make money, it is not a windfall. It is simply economic forces at work.

Furthermore, it is inconsistent with tax reform to have a tax of this sort, an excise tax, which causes a disincentive for one industry designated out from other industries. It is inconsistent with tax reform and that disincentive comes at a time when we do not need it for the oil and gas industry.

The other two tax rules that the President proposed are the repeal of the transfer rule and the net income limitation. They are both targeted toward marginal wells. The repeal of the transfer rule, the rule as originally put into law in 1975, is a safeguard against measures to avoid the 1,000 barrel per day limitation on percentage depletion. While it probably worked well in that regard initially, it also has the very significant effect of making marginal wells that are less attractive to a large producer, or someone who cannot use the tax benefits or someone who cannot bear the risk and uncertainty that the marginal well may become negative, because of a negative cash flow. Nevertheless, he is stuck with continuing to produce that well or just to shut it down. He cannot transfer it to another producer who can take advantage of the percentage depletion. Therefore, the value to a purchaser in the transfer is diminished by this percentage depletion factor.

We would think that if this rule is repealed, it would allow the transfer of these marginal properties to individuals who can make them cost effective, who will keep them open, who would be willing to spend money and the incentive of percentage depletion would encourage them to do so.

Likewise, the 50 percent net income limitation rule, we think, has the impact of closing some marginal wells. When a well is operating very much on the margin, the 50 percent limit will reduce the benefits of percentage depletion, obviously, 50 percent per property. If we increase the limit, at least the producer knows that he has that additional investment incentive, that additional incentive from percentage depletion to keep that well open. He would hope the price would rise and make it commercially productive and commercially profitable again.

So we think both of those rules would have a very positive effect, to keep open the marginal wells and should be considered and enacted.

With respect to the other tax proposals, there have been a number of other tax proposals in the various bills introduced and which are on the table for consideration today. These bills include such things as increasing the percentage depletion limitation, increasing it for independent producers in some cases or increasing it for all taxpayers. One of the bills limits it to new or enhanced stripper oil production.

The proposals also include expensing of G and G and surface casing costs, repeal of the Section 1254 recapture rule, repeal of a specific limitation on transfer in the windfall profit tax. Also increasing the 65 percent taxable income limitation, and the proposed exclusion of intangible drilling cost from the minimum tax.

Those provisions, or virtually all of them, were considered in the Energy Department study. We analyzed them carefully. We worked with the Energy Department in that study. And the President again considered those matters when the proposals were submitted to him for consideration for submission to Congress.

This discussion was carried out in the light of the fiscal constraints that we were all under as to how to pay for matters, the limit on budget outlays, and how to pay for tax measures which would benefit the oil industry, but at the same time raise tax cost.

These measures were also considered in the light of tax reform, which has just recently been enacted, in the fall of last year. And in light of those considerations, the President's proposals were more limited in nature than the broader scope of these other tax proposals. We think his proposals strike a sound balance among the considerations of energy security, fiscal responsibility, and the desire not to open tax reform.

The legislation before this subcommittee would go well beyond the President's proposals, as I have indicated. And the Administration is extremely aware of the energy security concerns and the concerns of the industry. And we also are determined that the domestic industry be strengthened in every way possible.

But for the reasons that I have just discussed—fiscal constraints, re-opening tax reform—we think that the President's proposals are the most responsible and effective means of improving our energy security and thus, the Administration does not support the other changes in the taxation of oil and gas which are proposed by these various bills.

That concludes my opening remarks.

Senator **Boren**. Thank you very much, Mr. Chapoton and Mr. Martin.

[The prepared written statement of Mr. Chapoton follows:]

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STATEMENT OF
O. DONALDSON CHAPOTON
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to present the views of the Treasury Department on various proposals under consideration by this Subcommittee to provide tax incentives to the domestic oil and gas industry. These proposals include the repeal of the windfall profit tax and revision of certain limitations on the percentage depletion deduction.

As you know, in the fall of last year, the President requested that the Department of Energy coordinate an interagency study of our nation's energy security and its implications for our national security. This request was generated by concern that the sharp reduction in world oil prices, although beneficial to the economy as a whole, was harming the domestic oil industry and resulting in increased dependence on foreign oil. The results of the study were reported in "Energy Security: A Report to the President of the United States" (the "Energy Security Report"), prepared by the Department of Energy with data and technical assistance provided by numerous other departments of the Administration. The Energy Security Report evaluated the nature and severity of the energy security problem and examined various remedial proposals.

The President recently transmitted to Congress a statement expressing his views and recommendations on the energy and national security concerns arising from the increasing levels of oil imports. The President's statement, which took into consideration the findings of the Energy Security Report, contained a number of proposals for improving our long-term energy security and strengthening the domestic oil industry. Several of these proposals recommend regulatory reforms that would enable the domestic energy industry to respond more effectively to our energy needs. The President's statement reiterated his support for repeal of the windfall profit tax and suggested Congressional consideration of repeal of the percentage depletion transfer rule and revision of the net income limitation on the percentage depletion deduction. Taken together, the proposals in the President's statement represent a balanced and cost-effective program for improving the nation's energy security.

Certain of the tax proposals in the President's statement also are included in legislation introduced by the Chairman and other members of the Committee, such as S. 200 and S. 255, which would repeal the windfall profit tax, and S. 233, which would repeal the transfer rule and the net income limitation. Additional tax incentives for oil and gas properties are proposed in S. 233 and other bills, such as S. 846.

In my testimony this morning I will focus first on the tax proposals recommended by the President, and thereafter on the other tax proposals before this Subcommittee. In evaluating these various proposals, we should be mindful that the tax treatment of oil and gas was exhaustively debated in the process leading to the Tax Reform Act of 1986 (the "Tax Reform Act" or the "Act"). The Act's treatment of the oil and gas industry and other sectors of the economy reflected a careful balance of competing policy and political interests. Basic issues considered in tax reform should not be reopened before the Act, with its benefits for the economy and individual taxpayers, is allowed to take effect.

In addition, this hearing comes at a time of increasing pressure to match the Federal government's spending with its existing revenues. Our consideration of proposals to assist the domestic energy industry must take account of current fiscal constraints, making it additionally important that we identify proposals that are cost effective and do not substantially affect the budget process.

I. The President's Proposals

As noted above, in the Energy Security Report the Department of Energy examined the impact of lower oil prices on the nation's energy security. The Report concludes that the primary threat posed by the decline in oil prices is the increase in the nation's vulnerability to potential foreign supply disruptions arising from our increased dependence on foreign oil.

One way to reduce the potential dangers inherent in the nation's increased reliance on foreign oil is to increase the amount of oil in the Strategic Petroleum Reserve ("SPR") through a higher fill rate. The President is prepared to support a fill rate of 100,000 barrels per day provided budget offsets can be found to cover the higher costs of this fill rate. An increase in the SPR fill rate would increase our available reserves and thus strengthen our ability to withstand a disruption in the supply of foreign oil. Other steps that have been recommended by the President, such as comprehensive reform of natural gas regulation, permitting environmentally sound energy exploration and development of the Arctic National Wildlife Refuge ("ANWR"), and reducing the minimum bid requirement for Federal offshore leases from $150 to $25 per acre, will improve the nation's energy security by allowing the domestic oil industry to meet more fully the nation's energy needs.

In addition to these important non-tax steps, the President has reiterated his support for the repeal of the windfall profit tax. The President also has suggested Congressional consideration of the repeal of the limitation on the use of percentage depletion by transferees of proven properties and an increase in the limitation on percentage depletion from 50 percent to 100 percent of the taxpayer's net income from the property. With the exception of the higher fill rate for the SPR, the proposals in the President's statement, taken together, are approximately revenue neutral over the 1988 to 1992 budget period. Although we do estimate a revenue cost from the tax proposals in the President's statement, this cost is offset by revenues gained from the non-tax proposals.

A. Repeal of the Windfall Profit Tax

Background. The Crude Oil Windfall Profit Tax Act of 1980 imposed an excise tax on domestically produced crude oil, subject to certain exemptions. The tax is paid by the producer of the oil and is deductible by the producer in calculating its Federal income tax. The tax base and rate depend on the classification or "tier" of the oil. Generally, tier one oil consists of oil that had been subject to price controls, tier two oil consists of stripper well oil, and tier three oil consists of newly discovered oil, tertiary oil and heavy oil. The tax base is the excess of the amount for which the oil is sold by the producer over the sum of an inflation-adjusted statutory base price (lower for tier one oil and progressively higher for tiers two and three) and a severance tax adjustment. The tax rate is 70 percent for tier one oil, 60 percent for tier two oil and 30 percent for tier three oil other than newly discovered oil. The tax rate for newly discovered oil is 22-1/2 percent through 1987, 20 percent for 1988 and 15 percent for 1989 and thereafter. Independent oil producers, however, are taxed at a reduced rate (50 percent) on 1,000 barrels per day of production of tier one oil and are exempt from the windfall profit tax on stripper well oil.

The windfall profit tax is scheduled to phase out over a 33 month period beginning in January 1991, or the first month after December 1987 in which cumulative net receipts exceed $227.3 billion, whichever occurs first. Cumulative net receipts for the fiscal year 1980 through fiscal year 1987 period are expected to be about $76 billion.

Description of the Proposal. The President's proposal would repeal the windfall profit tax for oil removed after the date the proposal is enacted. This proposal is also contained in S. 200 and S. 255.

Discussion. At the time the windfall profit tax was enacted, a dramatic increase in domestic crude oil prices was expected due to the decontrol of these prices. Although the price of domestic oil did increase initially to record highs, over the past several years, and especially in the last year, the price of oil has significantly declined. The average wellhead price of domestic oil fell from about $33.75 per barrel in 1981 to about $13.50 per barrel in 1986. Although prices in 1987 have recovered to the $18-$19 per barrel range, current prices are less than pre-decontrol prices when adjusted for inflation. Generally, the current adjusted base prices of tier 1, tier 2, and tier 3 are approximately $18.50, $21, and $27, respectively. As a result, very little windfall profit tax is being collected at the present time. More importantly, even if the price of oil rises above windfall profit tax base prices, the price increase would be due to the operation of market forces, and not to the decontrol of crude oil. Consequently, the "windfall" to producers from decontrol of domestic oil prices has already been subject to tax, eliminating any justification for continued imposition of the tax.

Although the windfall profit tax was not addressed in the Tax Reform Act, repeal of the tax is consistent with the Act's purposes to produce uniform rates of taxation and thus eliminate tax-induced distortions in investment activity. The extra cost imposed by the windfall profit tax on the production of oil creates a disincentive for domestic oil and gas exploration and development relative to other activities.

Based on the Administration's current oil price forecast, this proposal should not result in any significant revenue loss over the 1988-1992 budget period.

B. Repeal the Limitation on the Use of Percentage Depletion by Transferees of Proven Properties

Current Law. Under section 611 of the Internal Revenue Code of 1986 (the "Code"), for purposes of calculating taxable income, a depletion deduction is generally allowed for the production of minerals. The depletion deduction may be calculated under the cost depletion method or, with certain limitations, under the generally more favorable percentage depletion method. Under percentage depletion, the amount of the depletion deduction is generally equal to a statutory percentage of the gross income from the property (15 percent in the case of oil and gas production). The percentage depletion method, however, is available only to independent producers and royalty owners, and only with respect to 1,000 barrels of production per day. In order to preclude avoidance of these limitations, Congress adopted a restriction on the eligibility of transferred property for percentage depletion. Under this rule, percentage depletion is unavailable for oil and gas properties that have been transferred after they have been "proven." A property is "proven" if at the time of the transfer the "principal value" of the property has been demonstrated by prospecting or exploration or discovery work.

Description of the Proposal. The President's proposal would repeal the transfer rule for all properties transferred after the date of the proposal's enactment. A similar provision is included in S. 233 and S. 846.

Discussion. The recent decline in the price of oil has a particularly adverse effect on properties with marginal profitability (e.g., stripper wells). At current price levels, wells with high operating costs may be abandoned, particularly where additional expenditures, such as workover costs, are required. If such wells are abandoned, production is not likely to be resumed in the future.

The transfer rule's restriction on percentage depletion discourages the transfer of wells that are uneconomic in the hands of the current owner to an owner that is more efficient, more willing to bear current losses, or better able to utilize the tax benefits of percentage depletion. Repeal of the restriction will encourage such transfers and the continued operation of marginal wells.

Data contained in the Energy Security Report indicates that repeal of the transfer rule would be highly cost effective, resulting in a production increase of approximately 55,000 barrels per day by 1992. Based on the Administration's current oil price forecast, this provision is estimated to cost $130 million over the 1988-1992 budget period.

C. Increase the Limitation on Percentage Depletion from an Oil or Gas Property from Fifty Percent to One Hundred Percent of Net Income From the Property

Current Law. As described above, the percentage depletion deduction for oil and gas generally is equal to 15 percent of the gross income from the property. This deduction, however, cannot exceed 50 percent of the taxpayer's net income from the property (the "50 percent limitation"), computed without regard to the deduction for depletion. Where percentage depletion exceeds 50 percent of the net income from the property, the producer must deduct the lesser amount (or use cost depletion, if the resulting deduction is greater than the allowable percentage depletion). The portion of percentage depletion in excess of 50 percent of the net income from the property cannot be deducted in a subsequent year.

Description of the Proposal. The President's proposal would increase the net income limitation with respect to oil or gas production to 100 percent of the net income from the property, computed without regard to the deduction for depletion. This provision would be effective for taxable years beginning after the date of the proposal's enactment. A similar provision is included in S. 846, while S. 233 would repeal the net income limitation completely.

Discussion. At current oil and gas prices, the 50 percent net income limitation may significantly reduce the benefits of percentage depletion for production from properties generating a small amount of net income. The effect of the limitation is greatest on marginal properties that are most likely to be shut down as a result of the decline in oil prices. We believe that the loss of such production should be avoided, and that the limitation should be revised. The President's proposal increases the limitation to 100 percent, rather than completely repealing the limitation. In this manner, the taxpayer's oil or gas income from the property may be fully shielded from tax, but other sources of income may not be sheltered.[1]

The increase in the 50 percent limitation also is cost effective. Based on data from the Energy Security Report, the resulting production increase is approximately 58,000 barrels per day by 1990. The revenue cost of this proposal is estimated to be $189 million over the 1988-1992 budget period, based on the Administration's current oil price forecast.

II. Other Tax Proposals

As discussed above, the Administration's evaluation of additional tax incentives for the domestic oil and gas industry has been disciplined by revenue considerations and a desire not to reopen the Tax Reform Act. The current climate of fiscal constraint places a premium on cost effective measures with limited budgetary impact. Moreover, a proposal to broadly expand oil and gas tax incentives would place back on the table basic issues concerning the taxation of the oil and gas industry. These issues were the subject of exhaustive policy and political debate during the tax reform process and should not be reopened so soon after that legislation's enactment.

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[1] As discussed below, a taxpayer's depletion deduction for all oil and gas properties is limited to 65 percent of overall taxable income. In addition, both intangible drilling and development costs ("IDCs") and percentage depletion deductions are preference items for purposes of the alternative minimum tax ("AMT") for corporate and non-corporate taxpayers. The retention of the limitation on percentage depletion at 65 percent of the taxpayer's overall taxable income could reduce the benefit of increasing the 50 percent limitation. Further, where increasing the 50 percent limitation increases the percentage depletion deduction in excess of a taxpayer's basis in his property, it may, because of the structure of the IDC tax preference, lead to an increase in both the percentage depletion preference and the IDC preference. A taxpayer facing the AMT tax can actually pay higher taxes despite an increase in his percentage depletion deduction because of this potential double effect of additional percentage depletion on the amount of tax preferences. We are prepared to consider modification of the 65 percent of taxable income limitation and the treatment of percentage depletion under the AMT so that the increase in the 50 percent limitation will have its full effect.

We believe the tax proposals in the President's energy statement strike a sound balance among the considerations of energy security, fiscal responsibility and the desire not to reopen tax reform. The proposals affecting income taxation are technical in nature and target their benefits to marginal properties. The proposal to repeal the windfall profit tax, although more substantive in nature, is fully consistent with the tax policy principles at the heart of the Tax Reform Act.

Legislation before this Subcommittee, such as S. 233 and S. 846, would go well beyond the President's proposals in liberalizing taxation of the oil and gas industry. The Administration understands the energy security concerns that underlie this legislation, and is itself determined that our domestic energy industry be strengthened. For the reasons outlined above, however, we believe the tax and non-tax proposals in the President's statement are the most responsible and effective means of improving our energy security. Thus, under the present circumstances, the Administration is opposed to changes in the taxation of oil and gas beyond the proposals contained in the President's statement.

Increase Percentage Depletion Rates. S. 233 would replace the fixed percentage (currently 15 percent) depletion deduction for oil and gas with a sliding scale of percentages based on the particular taxpayer's annual average sales price for oil or natural gas (net of any windfall profit tax). Specifically, S. 233 would allow a percentage depletion deduction equal to the current 15 percent if the taxpayer's average oil or gas price is greater than $20 per barrel, 20% if such price is between $15 and $20, 25 percent if such price is between $10 and $15, and 30 percent if such price is less than $10 per barrel. These amendments would be effective for production during calendar years beginning after December 31, 1986. S. 846, on the other hand, would increase the percentage depletion deduction to 27.5 percent for all producers with respect to new, enhanced and stripper oil and gas production.

The revision in percentage depletion rates proposed by S. 233 is designed to preserve the dollar amount of percentage depletion benefits when the price of oil or gas declines, but not to increase those benefits above those provided by current law when prices rise. Since percentage depletion is based on the price of the oil or gas sold, increasing the rate proportionately as the price falls yields roughly the same level of benefits. Percentage depletion, however, tends to provide the greatest benefits to the producers of the most prolific wells, and relatively less benefits to the producers of marginal wells. In addition, the percentage depletion deduction tends to encourage more rapid production from existing fields. Targeting the increased benefits to new oil and gas (as is proposed in S. 846) would increase the initial cost effectiveness of the proposal.

Based on the Administration's current oil price forecast, it is estimated that the revenue loss from modifying the current percentage depletion allowance as proposed in S. 233 would be approximately $720 million over the 1988-1992 budget period.

Expensing of Surface Casing Costs and Geological and Geophysical Costs. The tax law distinguishes between expenditures that are capital in nature and those that are ordinary and necessary business expenses of carrying on a trade or business. Section 263 of the Code requires the capitalization of expenditures for permanent improvements or betterments made to increase the value of any property. Section 263(c), however, creates an exception to the capitalization requirement for intangible drilling and development costs ("IDCs") paid in connection with the drilling of oil or gas wells. Although capital in nature, such costs may be immediately deducted, subject to recapture as ordinary income on the sale of the property.

Under current law, surface casing costs and geological and geophysical costs ("G&G costs") are not included in the definition of intangible drilling costs. Therefore, as capital expenditures, both types of expenditures must be capitalized and are recovered through depreciation and depletion. Previously unrecovered G&G costs and surface casing costs attributable to a property that is later abandoned may be deducted in the year of abandonment. S.233 would amend the definition of IDCs for purposes of oil and gas wells to include surface casing costs and G&G costs, effective for costs paid or incurred after the date of enactment. S. 846 would treat G&G costs incurred after the date of enactment as IDCs.

The data presented in Energy Security Report indicate that allowing G&G costs to be treated as IDCs would increase production by approximately 200,000 barrels per day by 1992. We estimate that the revenue cost of allowing G&G and surface casing costs to be treated as IDCs would be $1.9 billion over the 1988-1992 budget period.

Repeal of Recapture of Gain from the Disposition of Oil, Gas or Geothermal Property. Section 1254 of the Code requires a portion of the gain recognized on the disposition of an oil and gas property to be "recaptured" (i.e., treated as ordinary income rather than capital gain). Prior to the Tax Reform Act, the amount subject to recapture was equal to the expensed IDCs. The Tax Reform Act amended section 1254 to also require the recapture of depletion deductions that reduced the basis of the property. This amendment applies to dispositions of property placed in service after December 31, 1986. S. 233 and S. 846 would repeal the current law recapture requirement for expensed IDCs and depletion deductions effective for dispositions after the date of enactment. Because the Tax Reform Act eliminated the preferential rate for capital gains, only a negligible revenue loss may be anticipated from the proposal.

Repeal the Limitation on the Stripper Well Exemption from the Windfall Profit Tax for Transferees of Proven Properties. As discussed above, an exemption from the windfall profit tax is provided for production from certain "stripper wells" where the working interest is owned by an independent producer (the "stripper well exemption"). Stripper wells are defined to include wells producing less than 10 barrels of crude oil per day. Generally, this exemption is unavailable where a person other than an independent producer owned such property at any time after July 22, 1981 when the property was proven. This limitation denies the stripper well exemption to all subsequent transferees of such property. S. 233 would repeal the current law provision denying the stripper well exemption to transferees of a proven property owned by a person other than an independent producer for oil removed after the date of enactment. As discussed above, the Administration has proposed complete repeal of the windfall profit tax.

Increase the Limitation on Percentage Depletion Deduction from Sixty-Five Percent to One Hundred Percent of the Taxpayer's Taxable Income. In addition to the 50 percent net income limitation described above, a taxpayer's depletion deduction for all oil and gas properties is limited by section 613A(d) of the Code to 65 percent of the taxpayer's overall taxable income (the "65 percent limitation"). For this purpose, taxable income is computed without regard to the depletion deduction, certain loss carrybacks and trust distributions. Under section 613A(d), amounts disallowed by this limitation are treated as an addition to the depletion deduction for the following year.

The 65 percent limitation reduces the extent to which oil and gas income may be offset by losses from other activities. Although the importance of the 65 percent limitation has been reduced by the adoption of new passive loss and minimum tax provisions in the Tax Reform Act, the limitation still remains applicable in certain circumstances.

It is estimated that, assuming no change in the 50 percent net income limitation, repeal of the 65 percent limit would result in a revenue loss of $50 million over the 1988-1992 budget period.

Exclude Intangible Drilling Costs from the Alternative Minimum Tax. Both IDCs and percentage depletion deductions are alternative minimum tax ("AMT") preference items for both corporate and non-corporate taxpayers. The percentage depletion tax preference is the amount by which the depletion deduction claimed for regular tax purposes exceeds the taxpayer's basis in the property at the end of the taxable year (disregarding the depletion deduction for the year). Prior to the Tax Reform Act, the IDC tax preference was the excess (if any) of the "excess IDCs" claimed with respect to successful wells over 100 percent of the taxpayer's oil, gas and geothermal net income, before IDC deductions (the "net income offset"). The "excess IDCs" are the deductions claimed for such costs over the deductions that would be claimed had the IDCs been capitalized and amortized over 120 months (or through cost depletion). The Tax Reform Act modified the calculation of the preference amount by reducing the net income offset from 100 percent to 65 percent. Thus, the Tax Reform Act increased the extent to which IDCs are treated as a preference item for AMT purposes.

S. 846 proposes to exclude IDCs paid or incurred after the date of enactment as a tax preference for AMT purposes. We estimate that the revenue cost of this proposal would be $1.4 billion over the 1988-1992 budget period.

This concludes my prepared statement. I will be happy to respond to questions.

Senator BOREN. As I understand it from your comments, Mr. Chapoton, on the proven property transfer rule, what you are saying is that there are those producers who simply cannot afford to produce marginal properties, stripper properties, at this time, and the major producers, for example, who are not entitled to get depletion on these properties. And if they transferred them to an independent producer, let's say a small producer, that producer, because of reduced costs, sometimes that producer will virtually pump those wells himself, in some cases, plus the additional benefit of getting depletion if there were not this rule in effect, might make it possible to keep those wells in production and not lose those wells. Is that correct?

Mr. CHAPOTON. That is correct, Mr. Chairman. It certainly enters into the economic decision of whether to purchase the well, in the first place, from someone else and to keep the well open, particularly when someone is facing a capital outlay. If a well needs to be re-worked or if new equipment is needed on the well, the future returns have to be factored in.

Senator BOREN. So really keeping this rule on the books just goes against our desire to try to preserve this stripper production in being and not waste that precious resource whenever possible.

Mr. CHAPOTON. That is true.

Senator BOREN. On the net income limitation provision, isn't it also true that at the very time that you most need to be able to take depletion on a property, particularly a marginal property, you might have a sitvation where that particular lease is making no income whatsoever and, therefore, you can have the ironic effect of reducing the benefit of depletion at the very time in which depletion is most needed in order to keep that property in being?

Mr. CHAPOTON. That is correct, Mr. Chairman.

Senator BOREN. Let me ask either one of you to respond. It has been clear from testimony that we are rapidly increasing ovr dependence upon foreign sources. When you lump the increases of consumption together with the decreased domestic production, we have had an increased reliance of something like 1.3 million barrels have gone from 20 percent to 40 percent dependence in a very brief period of time. We can argue whether we are going to, by 1990, tcp the 50 percent mark or whether we are going to be headed to a 60 percent mark.

But it is very clear that we are on our way toward an alarming dependence. Senator Bentsen has proposed that the President would have to come forward with additional steps to project exactly what steps he would take to prevent this dependence from growing once we reach that figure point.

Do you have any estimates in terms of the two technical changes that are made here today, or endorsed here today, on what you feel the windfall tax as to the amount of additional domestic production that that would encourage, and whether or not—and how much, percentage-wise, that would reduce our dependence upon foreign sources?

Mr. MARTIN. Yes, sir. It is about 55,000 barrels a day for the transfer rule and raising the net income limitation. So about 110,000 total.

Senator **Boren**. About 110,000 total. So that falls far short of what would be necessary to provide energy security for the country under the kinds of dependence, growing dependence that we are projecting. That being the case, I wonder what other kinds of alternatives the Administration or the President might have in mind to prevent us from going across that 50 percent mark as we seem to be moving inexorably toward it. What other proposals, as we look to the Administration, to the President, Department of Energy, for leadership in this matter? What other proposals would you suggest to us, since obviously these are valuable but woefully insufficient to keep us from increasing our dependence?

Mr. **Martin**. Well, first, Mr. Chairman, I think the nature of the problem and the security problem is reliance on the Persian Gulf. Therefore, any energy source, whether it is oil, coal, nuclear power, gas, can reduce that dependency. Likewise, any nation can reduce their dependency. So, therefore, we had looked very broadly at all energy sources and we had to look very broadly at what other nations were doing to contribute to greater energy security. That is why in the President's letter we do call for a speeded up SPRO bill, 100,000 barrels a day, to reach that 750 million barrel a day level by 1993.

We hope our allies will take similar steps so that, together, collectively, we can put about five million barrels a day of oil onto the market to prevent a disruption. That is in the area of emergency preparedness.

I agree with one of the Senators who said that is half the gain. The other is the basic problem of increasing dependence.

We have also called for clean coal technology, nuclear licensing reform, these measures. And as the President said in his last paragraph of his letter to you, we are going to monitor the situation, and if further actions are required, if the industry diminishes further or if national security is threatened, more action will be warranted.

Senator **Boren**. Thank you.

Senator Bentsen.

The **Chairman**. Thank you very much, Mr. Chairman.

Mr. Martin, we looked forward to receiving your report with considerable eagerness because we were looking for something that would help us craft a policy that would protect this country from another embargo. We had received a report from the Harvard School by Dr. William Hogan, which said that an oil import fee made economic sense. The Energy and Environment Policy Center at the Kennedy School said the cost of an embargo is so high that an oil import fee is a justified insurance against an embargo; it makes economic sense.

Now, your study looked at the same question and came up with a different answer. I can understand that. I have seen that economists can come up with just about any answer they want to come up with by varying the assumptions.

But what was particularly interesting about your study were the things that you left out of your study. You did not examine the impact of an embargo which occurred before 1995. You did not examine the use of an import fee in the form of a variable fee that would establish a floor on the price of oil, and you did not examine an embargo that had economic effects that lasted longer than one year.

Now let's review a little history on that. Our economy took six years, not one, to recover from the embargo in 1973. In current dollars, according to George Perry at the Brookings Institute, the cost was over $500 billion in lost income. We have other reports that the cost was as much as $700 billion in lost income.

We had a recession in both 1974 and 1975. Inflation hit double digits; it went up to 12.6 percent in 1974. Three million people were thrown out of work. We had more people out of work by 1975 than we had had since the great depression. And you sit there and tell me that a $3.00 per barrel or $5.00 per barrel import fee would have a greater economic impact than that. What I really think you have done is developed a sterile study with no applicability to policy development.

Take a look at what is happening in the Persian Gulf. When we talk about a preemptive strike possibly taking place on silkworm missiles, we are talking about something of great magnitude to our country. We are looking at lives that have already been lost there. We are seeing a growing dependence on a politically unstable area. That is what gives me concern.

Would you care to comment on that?

Mr. MARTIN. Yes, sir, I would like to. If you look back to 1973, 1974, you are absolutely right. That was one of the worse recessions since the World War II, because of the price rise. Let me remind you the price rise for that period was about $10.00. And we saw at that time how pervasive oil is in the economy and, likewise, we recognized in the Energy Security Report if we have a very severe disruption, we are going to be paying a lot in terms of lost GNP, inflation and jobs.

Let me also say that if we put upon ourselves a $10.00 fee, let's take the $10.00 fee for a moment, because that——

The CHAIRMAN. I said a $3.00 fee.

Mr. MARTIN. All right. But a $3.00 fee does not get you the response that you need to really stimulate supply. We started here with $15.00.

The CHAIRMAN. It nets a lot more response than what you are proposing, Mr. Martin.

Mr. MARTIN. Well our $10.00 case nets a million and a half barrels a day less imports into this country. That is comparable to what the Hogan study says at Harvard.

Let me also say that one of the reasons Bill Hogan concludes the import fee is in the national interest is he assumes that the revenues generated are recycled back into the economy and not taken away as a reduction in the deficit. That is a very important assumption. Nobody I have heard in the Congress looking at the oil import fee tells me that they are going to recycle it back in the economy. They are going to take it as a tax to reduce the deficit. That is a very worthy goal.

But one of the things that we said about in the oil import analysis was to be very open about our methodology or assumptions or results so that others could come and look at it and give us their views. And that is precisely what we hope will happen now.

The CHAIRMAN. Let me ask another question of Mr. Chapoton.

Mr. Chapoton, you speak of your concern about going beyond what the President has proposed in the way of tax incentives because we have just done the tax reform bill. We do not want to open it up again. That is one of the reasons. Yet you support the President's proposal to increase the net income limits from 50 percent to 100 percent and his proposal to repeal the so-called transfer rule.

Those cost money. How do you distinguish those proposals and other tax incentive proposals, such as expensing of geological and geophysical costs, higher percentage depletion on new discoveries for independents, and the use of credits that we have talked about on the studies that Senators Boren and Dole and I had the Joint Tax Committee do and the Finance Committee do.

What is the difference? You know, I went through that fight on tax reform and I well understand it. What is the difference between what you are supporting from that standpoint and some of these other proposals that might be helpful?

Mr. CHAPOTON. Well, Senator, first, I agree they do cost money. Let me address that, they cost a little over $300 million over the 5-year budget period. But, taking the President's proposals as a whole, the non-tax provisions also raise some money. The opening up of ANWR, the sale of some off-shore leases, the various proposals in there did raise some money. So that on an overall basis, the President's proposal is revenue neutral.

But I also agree that it does raise the question of whether this is re-opening tax reform, or is different from the others.

The answer to that though is that these are very technical provisions which were designed at a time when we think that those principles——

The CHAIRMAN. I can draft them where they will be very technical. [Laughter.]

If that is the criterion. You know, I looked at this tax reform bill that the Administration proposed. We had a little over 2,000 pages of simplification.

Mr. CHAPOTON. Senator, I understand your point, and I think it is a valid one. What I am saying though is that they are very small, technical in nature and they do not get into the basic principles of tax reform, such as creating special incentives for the oil industry, like increasing percentage depletion or providing a credit for IDC. These latter issues were basic to the very principles discussed in tax reform and were rejected. The tax reform went the other way. These fixes on the net income limitation and on the transfer rule are simply designed to avoid rules which were working wrong, but were not reconsidered in tax reform.

The CHAIRMAN. Mr. Chairman, I see that my time has expired. Thank you.

Senator BOREN. Thank you very much, Senator Bentsen.

Senator Daschle.

Senator DASCHLE. Thank you, Mr. Chairman.

Mr. Martin, recently an official was quoted as saying that never before has a major national crisis been as predictable as the next energy crisis is today. Do you share that view?

Mr. MARTIN. I think unless we take effective action today then we could face a crisis in the 1990s. But I also have to admit our forecasting records have been pretty bad in the past. But I think the directions are very clear, that unless something changes, we are going to see a crisis equal to or exceeding what we saw in the early 1970s.

We will certainly see a level of dependency on OPEC, at least our own imports, which is greater than the 1970s. The thing that is different about the 1970s is we do have the strategic petroleum reserve, which will help, but that does not last forever.

Senator DASCHLE. Well, conservation was a major part of our response to the crisis in the 1970s. What is the Administration's view towards conservation today?

Mr. MARTIN. Well I think it is quite remarkable that we don't use any more energy today than we did in 1975. We use less oil. That is true, not only here but in every major industrialized country. That is very good news. And we think that will continue.

Senator DASCHLE. So you don't dispute the fact that on a per capita basis, some energy consumption has been reduced by about 40 percent due to conservation techniques. Is that correct?

Mr. MARTIN. I would have to check the 40 percent, but, clearly, it has been significant.

Senator DASCHLE. Significant. Well, that is how I feel about it. I am impressed by what we have done through conservation, especially with the increasing dependency on foreign oil. But it does give me pause. And I would be interested in your explanation as to the Administration's rationale for reducing funding for energy conservation programs in its budget from $776 million in fiscal year 1980 to a proposed $86 million in fiscal year 1988.

If conservation is that important, and if it can be demonstrated that it has worked a 40 percent reduction on a per capita basis, at least according to some sources, how is it that the Administration can justify reducing the budget for conservation as dramatically as that?

Mr. MARTIN. Well because we think that most of what is happening with conservation is primarily in the marketplaces as consumers respond to higher prices. Clearly, on the budget side——

Senator DASCHLE. That is your proposal for conservation, just higher prices?

Mr. MARTIN. I think that that has been the reason that conservation has taken hold.

Senator DASCHLE. But consumers are aware of lower prices, aren't they? Aren't they lower today in a constant dollar value than they were five or six years ago?

Mr. MARTIN. They are. Undoubtedly, lower prices will have some impact. But also we have to remember that the average miles per gallon in our fleet is twice what it was a decade ago, and there is a 1987 car this year replacing a 1977 car. New industry processes are usually more energy efficient. New housing starts are. So that conservation will continue, we think, to make major contributions. And $86 million of support for R&D we think is quite a bit of money and we need to use it wisely.

Senator DASCHLE. But what can you show for it? I mean, obviously, we were benefitting for a while with the kind of commitment the government was making in partnership with the private sector, committing almost a billion dollars to coming up with ways that you have just cited as proof positive that the conservation has worked. Now you are saying that you are going to spend less than 10 percent of what we spent in 1980. So, in constant dollars, perhaps 5 percent of what we were spending in 1980, fully expecting, as you have just indicated earlier, that we could see a crisis equal to if not exceeding what we had in 1973. Doesn't that seem incongruous to you?

Mr. **Martin**. No, it doesn't, because I have never seen a case where just putting a lot of money into something solves the problem. I think, for example, we had cafe standards in the 1970s. I have been on record as saying I thought that was very useful at the time. Now I think we are reaching diminishing returns on cafe standards. We need a new concept.

One of the things that were focused on out of this report is a study on alternative fuels for transport, because, clearly, oil is concentrated in the transportation sector. That is the long-term problem we face. And we need to study that quite a bit.

Senator **Daschle**. Well, I see my time is up, Mr. Chairman, but I really think, Mr. Martin, you are going to have to reconsider. I am one who is a little bit disappointed in the President's proposal, and I think that, as narrow a proposal as it was, it would do us all well if the Department would go back and reconsider its positions on energy and some of these other issues.

Clearly, when one considers conservation and the potential that it has demonstrated for savings, there is a lot more that can be done, and $86 million just does not cut it, in my view. Thank you, Mr. Chairman.

Senator **Boren**. Thank you very much, Senator Daschle.

Senator Matsunaga.

Senator **Matsunaga**. Thank you, Mr. Chairman. I wish, first of all, to commend you for holding this hearing on tax incentives to increase our nation's energy security. It is my firm conviction that unless we establish ourselves as an energy self-sufficient nation, we shall never be able to fully and effectively control and determine our future's economic destiny.

Of course, our nation today is much too dependent upon foreign sources of oil and gas, and I do hope that this hearing will give us an opportunity to focus on the risks of this import dependency.

While Hawaii produces no oil at all, we have our steaming volcanoes, our deep ocean, our tropical sunshine, our constant winds, all of which can be used to generate electricity. I feel that in addition to looking to resources of oil and gas, we need to look to other alternative sources, and for that reason, I have long been a strong advocate of tax incentives for the development of alternative sources of energy: wind, sun, sea, biomass, geothermal, et cetera.

Now as I understand it, both the Department of Energy and the Treasury Department support the repeal of the windfall profit tax.

Mr. **Chapoton**. That is correct.

Senator **Matsunaga**. As you point out in your prepared statement, Mr. Chapoton, you state that current law provides for the termination of the tax in 1991.

Mr. **Chapoton**. It will finally expire starting in 1991, I believe.

Senator **Matsunaga**. 1991.

Do you believe that because of that provision, we do not need to hasten the repeal of the tax?

Mr. CHAPOTON. Oh, not at all, Senator. We think the tax should be repealed immediately.

Senator MATSUNAGA. I see.

Mr. CHAPOTON. That allowing it to terminate by its own provisions under the phase out provisions will be too long and will continue to be a disincentive for the exploration of oil and gas, a very significant disincentive.

Senator MATSUNAGA. Relative to the oil in Alaska, what sort of plans does the Department of Energy have?

Mr. MARTIN. Well, first, Senator, I think we have to recognize that our great reservoir on the North Slope, Prudho Bay, is likely to peak and decline within the next few years. And it has been that production which has maintained the total level of U.S. production. So when that begins to decline—and we estimate Prudho can go from 2 million barrels a day down to maybe 500,000 barrels a day by the end of the century—we really will need to replace that. And our hope is that the ANWR Refuge can be opened up for exploration to see if indeed there is oil there and, if so, how much? So we do support the opening up of ANWR and the Secretary of the Interior is working on this.

Senator MATSUNAGA. And do you estimate an increase in the search for oil if we remove the windfall profits tax?

Mr. MARTIN. Mr. Campbell, if you would allow, can answer that specifically.

Mr. CAMPBELL. Yes, Senator. For each dollar rise in oil prices you take away the windfall profits tax. We estimate we will generate 15,000 to 25,000 barrels of daily production.

Senator MATSUNAGA. For each dollar of removal?

Mr. CAMPBELL. For each dollar rise. Right now, the windfall profits tax, when we cross $19.00 in development drilling, it will take 70 cents of every dollar price rise. If we can repeal this tax today, we think we can generate another 15 and ultimately 25,000 barrels a day of production each year with each dollar rise in price.

So what we are talking about today are critical barrels of oil that will be needed for this country to help overcome the losses that we have incurred to date. Over 800,000 barrels a day have been lost in production. So we see it as a critical matter that needs to be done immediately.

Senator MATSUNAGA. What effect do you see on the consumer?

Mr. CAMPBELL. Well the consumer pays later. The problem is that——

Senator MATSUNAGA. How much later?

Mr. CAMPBELL. It could be as early as the early 1990s. In our Energy Security Report we showed that we enter a period of vulnerability between 1990 and 1995 as our dependence on the Middle East grows and as our production continues to fall. So we do face a serious threat of supply disruptions, of higher prices—the problems have been outlined by the Senators on the panel—if we do not do something.

Senator MATSUNAGA. You are going on the assumption that the supply will decrease dramatically?

Mr. CAMPBELL. It is continuing to decrease and our imports are continuing to rise at this time. It has slowed somewhat from last year, but it is still very troubling. And that is why the Department is watching it very closely. And if the situation continues to deteriorate, we will go back to the President and make additional recommendations.

Senator MATSUNAGA. I see my time is up, Mr. Chairman.

Senator BOREN. If you have other questions, please continue.

Senator MATSUNAGA. In conjunction with your program to increase domestic sources of oil, do you have plans to make up for the oil depletion by promoting the development of other sources, such as gas, natural gas, or alternative energy?

Mr. CAMPBELL. Yes, we do, sir. As the President had outlined earlier, we are making a major commitment to clean coal technology. We are looking at alternative fuels. And we realize it is just not an oil problem but an energy problem, and we have to look at all sources. That is particularly important now because this country is dependent upon oil as a primary fuel. That is not going to change in this century.

Senator MATSUNAGA. It is not going to change?

Mr. CAMPBELL. It is not going to change in this century. Now at the turn of the century we will see ourselves becoming more increasingly dependent on other more available sources of fuel, but for right now our future and the strength of this nation is linked to oil.

Senator MATSUNAGA. Thank you, Mr. Chairman.

Senator BOREN. Thank you very much, Senator Matsunaga.

Obviously the two technical changes are not going to generate a sufficient production response that have been supported here today to prevent us becoming increasingly dependent. And I am not so sure that I can agree with the fact we just only have concern about the Persian Gulf because, obviously, if the Persian Gulf is disrupted severely in any way, all the other nations that are getting oil from the Persian Gulf now will become competitors with us to get oil from Mexico, or Latin America, or Africa, or wherever else it is.

And if we have a 3 or 4 million barrel short-fall of oil internationally, compared to demand, we know that that can cause immense escalation in price, and that could certainly greatly upset our balance of trade again further, in addition to our national security interest if we are not producing more here at home. Isn't that correct?

Mr. MARTIN. That was the lesson of 1979.

Senator BOREN. That's right. And that is the reason I am concerned. I hope that the Administration is not focusing just upon. I hope that they are looking at our dependence upon sources outside this country and not just on our dependence upon the Persian Gulf, although that has been growing, as you know, as well.

Now given the fact that these steps are clearly insufficient to prevent us from getting to a 50 percent or greater dependency rate, listening to the testimony of the three of you, it sounds to me like you are really placing your hopes on a sufficient increase in price. And we are talking about every dollar if the windfall profits tax were not still being imposed, every dollar increase in the price of oil would generate, what did you say, 50-some——

Mr. **Campbell**. Fifteen to 25 thousand barrels.

Senator **Boren**. Twenty-five thousand barrels of additional production. So you are counting on, it sounds to me like, since there are no other proposals before us, except these very small ones from the Administration, you seem to be projecting some increase in price and removal of the windfall profits tax becomes an important part of your strategy for increasing domestic production. Is that correct?

Mr. **Martin**. Yes.

Mr. Chairman, it is important to note in energy security we looked at two price paths. The low price did result in 60 percent dependence on imports. The low price, however, was much less than that—the high price case—and right now we are on a high priced projectory, given the recent improvement in the oil price. So that is why we have to monitor that.

We also have to monitor the surplus capacity around the world. We have to monitor the stock situation. We have to monitor what is happening to conservation and other things. But we think right now some may think it is half a loaf, but we need to get working on the half a loaf and get that done.

Senator **Boren**. Well I agree we need to go forward with what is proposed here. But again, I would say that I think that what is being proposed by the Administration falls woefully short of any kind of plan that would keep us in any reasonable level of security for our country in terms of our domestic energy security. And it becomes very clear that an important part of the strategy, if this is to have any impact at all, repeal of the windfall profits tax is a crucial part of it.

We have seen the President and the Administration go into action before. I can tell you that I have never seen so much action as took place on passage of the so-called tax reform bill, which I think those of us from Oklahoma unanimously voted again. But the delegation will be increasingly proud as the years go by. We have discouraged investment, and saving, and all the things this country needs through that Act. But I have seen the full operation of the Administration's influence on Central American policy, where I happen to have supported them. I have seen the influence of the Administration work on the sale of AWAC planes. We have seen numerous examples of places where if the President really cared with heart and soul about getting something done before resources of the Administration had been mobilized. I notice when we discussed repeal of windfall profits tax last year, I think after a few telephone calls and pleading with people to come down, two or three people came down at the last minute and said, yes, officially, we support the repeal of the windfall profits tax.

What I would like to know is are we going to see the kind of heart and soul effort in the marshalling of the full resources of the Administration, not just lip service or support official at hearings, but marshalling the full resources of the Administration on an urgent basis to say that looking at where we are going with energy security, we must have the repeal of the windfall profits tax as soon as possible.

Can we expect that kind of heart and soul effort out of the Administration for this proposal?

Mr. MARTIN. Mr. Chairman, we have been working hard for a year on energy security, as witnessed by our long document, which now I think is basically recognized as a good problem definition. We also have the President's letter before the Congress and a number of initiatives to go forward with, including comprehensive natural gas. So I think we have a program that we want to work with the Congress on, including these, and we want to debate the issue and hear what you have to say, and we will work together.

Senator BOREN. Well when they came out, when they were working for tax reform and all these things, they did not come to debate. They came to convince. They had people up to the White House. They had even people up to the residence. They talked about the urgency of doing something. There were speeches to the nation. There were radio addresses. There were press conferences. And what I am asking you is, can we hope to see this kind of effort and this kind of priority given to the Chief of Energy Security for this country that we have seen given to other, in the opinion of some of us, at least on some measures like tax reform, so-called far less important than this for the country? Can we hope for that? Can you hold that little light at the end of the tunnel for us?

Mr. CHAPOTON. Mr. Chairman, I think we can assure you that the Administration enthusiastically endorses the repeal of the windfall profit tax. It is in the President's budget. We discussed it a number of times with various members of this committee. We think it is inconsistent with tax reform. It is an unfair disincentive at a very poor time. And so we will actively seek to get it repealed at an early possible date.

I might mention, when I answered Senator Matsunaga's question a minute ago I simply said the tax goes to 1991. It actually begins phasing out in 1991 over a 33-month period. So if we do not repeal it now, it is going to be around for a while.

Senator BOREN. I suspect we are up through about to 1995, roughly, aren't we?

Mr. CHAPOTON. I think that is right. I would also like to point out, as Deputy Secretary Martin has, that while the tax measures in the President's proposal are limited, there are a number of other measures to increase domestic production and I do not think we should overlook those, such as deregulation of natural gas, opening of ANWR.

Senator BOREN. Thank you very much. We appreciate your being with us, and we hope that you will encourage the mobilization of the Administration behind this start that we need to at least get underway.

Our next panel is Dr. William Fisher, University of Texas, Director of the Bureau of Economic Geology, in Austin; Mr. Raymond Hefner, the Chairman of the Independent Petroleum Producers Association of America; Mr. Wayne Gibbons, the President of the Mid-Continent Oil and Gas Association; and Mr. James R. Cummings, a Partner at Deloitte, Haskins, and Sells, Denver, Colorado.

We are very pleased to have this group with us. And, again, I would ask that in the interest of time—I am told we are going to have a vote over on the Senate floor fairly soon—but in the interest of time, if you can possibly summarize your opening remarks, and we will receive your full statements for the record.

Since I saw Dr. Fisher seated first, and since Oklahomans always try to be gracious to those who cannot quite have it as good as the rest of us, who live in Oklahoma but have to live in Texas as the second choice, why I will call on Dr. Fisher first. And we are very glad to have you with us.

STATEMENT OF DR. WILLIAM L. FISHER, UNIVERSITY OF TEXAS, DIRECTOR OF ECONOMIC GEOLOGY, AUSTIN, TX

Dr. FISHER. Thank you, Mr. Chairman. I should like to commend you for holding these hearings because I think incentives—and I would add substantial ones--are going to be necessary if we want to avert further very deep erosion of the oil production capacity in this country.

We saw a decline last year of 10 percent, but I want to point out that Alaskan production, which is 20 percent of our entire production, held steady last year, and it is scheduled to go in decline in the next year or so. The outer continental shelf production of oil is 12 percent of our total supply. It held steady last year, but development drilling was down 50 percent in the OCS. So we see those two critical areas that held in 1986, heading for decline very rapidly.

We also see natural gas deliverability going down. So we are rapidly losing, I would contend, a significant part of our production capacity in this nation under the kinds of price situations that we see at the present time.

This need not be. We have an adequate resource base, and I think one can demonstrate it to a very wide extent that a significant volume of the resources can be made available at a moderate cost. We are not talking about escalating prices. We are talking about prices in a fairly moderate sense.

I think if we really want to reduce the severe erosion of oil and gas production capacity and to move to a stabilization of production at a level of the kind that we had in the early 1980s and a constraint of imports, there are three things we have got to do.

One is to provide for a stable floor price, at least for new domestic production; second, I think we have to use the Tax Code for incentives for targeted areas, particularly such as new field exploration and enhanced oil recovery. And there I am talking about some significant provisions of the Tax Code, not the rather minor corrections of technical things we were talking about earlier this morning. And, finally, I think it would be to a great advantage to significantly enlarge oil and gas recovery research and development in this country. We do very, very little in that way.

As far as the floor prices is concerned, we are now seeing prices moving toward the $20.00 range. But if you look at the level of activity that is actually going on in exploration and development, it is as though the price were in the, say, 15 or 16 dollar range.

The volatility and the uncertainty that is associated with that price—I interpret, Mr. Chairman, will persist—will lead to a discount of about 25 percent. If we were to stabilize the price with a floor mechanism, then we would see the full investment level for the price which the consumer is paying. A volatile $20 price is just as expensive to the consumer as a stable $20.00. So that stabilization, if we were to do that, I think it would result in the additions yearly of about 300 million barrels of oil.

Senator BOREN. Of how much?

Dr. FISHER. 300 million barrels a year, above and beyond what it would be if it were discounted down to $15.00.

Senator BOREN. It is almost a million barrels a year.

Dr. FISHER. About a million barrels a year in production capacity.

And the Tax Code, in addition to a floor price of $20.00, which I think would be very important, there are certain kinds of strategic reserve replacement that you simply will not get at $20.00. We are going to have to look at some incentives: certain kinds of new field exploration are in that category; enhanced oil and gas recovery is another. There are a number of pieces that are necessary.

I think the kinds of incentives that could be offered through the Tax Code ought to be the substantial ones. I support the smaller ones that have been indicated. They will give you 50,000 to 100,000 barrels of capacity, but we are talking about a loss of 2 million barrels a day. And so you have really got to do 20 times better than what we are talking about here if you want to keep production at a reasonably stable level.

Allowing G&G—geological and geophysical—costs to be expensed in the same way as IDCs would be a significant step. A lot of the resource base that we have left is particularly amenable to that kind of an investment if we were to make it.

It would give us 80 million barrels a year if we were to permit that.

Another important incentive would be a comprehensive tax credit that would allow a 5 percent tax credit for all exploration and drilling expenditures. If we would do that, it is worth about 130 million barrels a year, or about 360 thousand barrels per day of production capacity. That incrementally would come on in the face of that.

A third major kind of incentive that I think we should be looking at is restoration of percentage depletion on an unlimited amount of production, up to 27.5 percent. This would be a major tax incentive and would result in about 145 million barrels a year of incremental production over the next 5-year time period. That is about 400,000 barrels per day.

If you take all of these incentives, including the floor price—they would basically apply these to new productions—you still have to make some special provisions for stripper wells in existing production. Something on the order of a 10 percent tax credit for well workovers or for any kind of asset that was put into service on those wells, I think, would be very helpful. And I think that would give an estimated 25 million barrels a year of production at those particular prices.

Now in addition to these incentives, let me make one point here relative to public sector R&D and oil and gas research.

I think we ought to do it. The investment that DOE makes now is one-half of 1 percent of their research budget directed to oil and gas research. One-half of 1 percent, and that is for oil and gas which supplies 65 percent of our energy sources in this country.

I think there are a lot of elements of the resource base where recovery could be improved two and a half to three times if we were getting the kind of efficiencies that could come under this investment.

Mr. Chairman, in conclusion, we are talking about a range of major incentives. These would cost us something on the order of about $2 billion a year, even assuming you have to make up at least $2.00 a barrel on the floor price, but they would give you almost a billion barrels a year worth of incremental reserves, better than 2 million barrels a day of production capacity. That would keep us at the stable levels of production we enjoyed in the first part of this decade, and the levels of imports that we enjoyed in those particular times. And it is those kinds of steps that I think we have to take to really seriously reduce the chances of price shocks and all the disstabilization that occurs from then and the supply interruption that come from an embargo.

Thank you, sir.

Senator BOREN. Thank you very much, Dr. Fisher. And we will entertain questions after we have heard from the other members of the panel.

Your full statement will be received, and any additional statistics that you would like to submit or background data you would like to submit in regard to the estimates of production response that you have given I think would be very, very helpful for the record.

We will next turn to Mr. Hefner, the Chairman of IPPAA, and also I might say a long valued energy advisor of mine, and a person with deep understanding of the problems of the industry. Mr. Hefner, we are glad to have you.

[The prepared written statement of Dr. Fisher follows:]

Statement
of
William L. Fisher

Mr. Chairman and Members:

I.

I commend you and the Committee for holding these hearings on possible incentives to modify the severe production decline in petroleum we are experiencing in this country. Incentives, substantial ones, are needed if we are to avert further deep erosion of production capacity in this country and avoid massive dependence on imported oil from the unstable Middle East.

More than 10 percent of U.S. capacity for oil production was lost during 1986, much of it permanently. Current levels of oil drilling will drop reserve additions to a level such that a 6-percent production decline in the lower 48 is set for at least the next five years. Last year Alaskan production, 20 percent of the U.S. total, held steady, but North Slope production is scheduled to decline about 12 percent per year beginning sometime next year or early 1989. Production of oil from the U.S. OCS, 12 percent of U.S. total, held steady in 1986 though the 50-percent decline in development drilling that took place is a sure sign of future decline. I projected, in a response to Senator Bentsen in March of this year, an average U.S. lower 48 production rate of 4.7 mmb/d for the first half of the 1990 decade (4.8 mmb/d in 1990 and 4.5 mmb/d in 1995). With similar assumptions of price, the U.S. Department of Energy in their March 1987 Energy Security Report to the President projected

U.S. lower 48 crude production at 5.3 mmb/d in 1990 and only 4.1 mmb/d in 1995, an average of 4.7 mmb/d for the first half of the 1990 decade.

U.S. natural gas production has declined by nearly 25 percent since the early 1980's; while a surplus still exists there is a critical loss of underlying deliverability caused by low levels of drilling in turn driven by loss of demand for natural gas. Last year and this year the demand loss is being aggravated by substitution of imported oil.

We are clearly heading for significant loss of hard-worn domestic petroleum producing capacity and a return to levels of imports exceeding those of the turbulent energy years of the 1970's. There is no argument from anyone whether these events will occur, only on timing, and that difference is not significant.

II.

Mr. Chairman, such ominous trends need not be. The U.S. can have relatively stable production and modest levels of imports and, I submit, do so at moderate, not high costs.

Recent geologic analyses and the analysis of the results of reserve addition response to drilling from the late 1970's through 1985 are fundamentally altering the conventional wisdom that discovery and production of oil and natural gas follow symmetrical life cycles, increasing exponentially, peaking, and then declining exponentially. Further, conventional wisdom held that reserve appreciation of discoveries would occur with initial, conventional, primary, and secondary development, but would then remain static; further recovery or reserve appreciation would be only marginal and very high cost and would not significantly alter the basic life cycle with its inevitable exponential decline.

With the conventional views in sway and with exponential decline in production underway in the 1970's, the U.S., as a matter of national policy turned to the more exotic sources of hydrocarbons--synthetic fuels, ultra deep gas, gas hydrates, shale oil and gas, and costly residual oil. The OPEC set their bench mark price just below the assumed upset price for developing these sources on the assumption that such were the competing sources.

But with increased drilling of the past decade the unpredicted occurred: Reserves from conventional oil and gas resources were added proportionate to the drilling effort. Production in the maturely explored and developed U.S. lower 48, in an exponential decline universally assumed to persist, was stabilized and then increased. The underlying reasons: (1) rates of discovery remained stable and did not decline, and (2) reserve growth in older existing fields through infill and extensional, conventional drilling vastly exceeded expectation. These two basic facts constitute the tangible potential for stable oil and gas production over several coming decades and the underlying rationale for the necessary incentives to realize expected high payout.

Contrary to the commonly held view that oil and gas resources in the maturely explored and developed U.S. are nearly exhausted and that reserves have been rapidly depleted, the volumes remaining for both discovery and extended recovery are huge. Some 625 billion barrels of oil remain, four times the combined volumes of historically produced and current proved reserves. Gas resources on the order of 2000 TCF are judged to remain, three times the total volume already produced and expected to be produced with existing development.

Recent geologic and engineering studies and assessment of volume balances of ultimate oil recovery and residual oil in swept portions of existing reservoirs indicate that a substantial volume of the remaining oil resource--between 25 and 80 billion barrels--can be converted to producible reserves at moderate costs ($20 to $25 per barrel, 1986 dollars). These studies and assessments are also supported by the volume and composition of reserve additions achieved from the late 1970's to the middle 1980's.

At somewhat higher costs ($25 to $40 per barrel, 1986 dollars) and with enlarged understanding of reservoirs, an estimated 200 billion barrels can be converted to producible reserves, sufficient to provide stable U.S. production to the middle part of the next century.

Comparable, but more preliminary, geologic, engineering, and volumetric analyses of natural gas suggest that from 135 to 415 TCF can be converted to recoverable reserves at moderate costs (less than $3.00 per MCF, 1986 dollars). At somewhat higher prices ($3.00 to $4.50 per MCF, 1986 dollars) an additional 750 TCF is available.

III.

A characteristic of the remaining oil and gas resource in the U.S. is that its cost-effective recovery depends chiefly on substantially increased efficiencies; it is, however, particularly amenable to specific, targeted research. The larger volumes of the resource base accessible at moderate costs are dependent upon improved efficiencies in recovery. But such can be gained through targeted research and development. The large volumes are equivalent to reserve additions necessary to maintain production at 1985 levels for 25 years. The volumes accessible at somewhat higher costs are sufficient to the middle part of the next century.

IV.

Will the ample potential of the U.S. oil and gas resource base be realized? Under current conditions, only partly and much less than needed for adequate production. Under current prices, successful oil completions will number about 16,000 in 1987, down from an average of 19,000 in 1986 and an annual average of about 38,000 during the first half of the 1980 decade.

Some rebound may occur, but absent action by the U.S., completions will not exceed 20,000 annually for the balance of this decade and probably not in the early 1990's.

Annual reserve additions for the lower 48 thus will average about 1.5 billion barrels, or about 65 percent of the average levels achieved in the first half of the 1980 decade. The bulk of additions will come from recovery of additional mobile oil by infill drilling in existing reservoirs, the lowest cost part of the U.S. oil resource base. About 1.6 mmb/d, or 80 percent of the 2 mmb/d of lower 48 production loss from 1986 through 1990, will come from foregone drilling. Virtually all the loss from 1990 through 1995 will be from foregone drilling.

The production outlook in Alaska must be considered separately. Average annual production in Alaska during 1986 was about the level of 1985. However, the supergiant Prudhoe Bay field is expected to go into normal production decline sometime during 1988. That decline is expected to be at an annual rate of 12 percent, so that through 1990 some 400,000 b/d of current capacity will be lost. Continued decline through 1995 will reduce Prudhoe Bay production to about 780,000 b/d. Under current prices about 200,000 b/d of capacity is expected to be developed from currently discovered but undeveloped reservoirs, giving a 1995 Alaskan production of just under 1 mmb/d.

V.

If severe erosion of U.S. oil and gas production capacity is to be averted, the U.S. must take three basic steps: (1) provide for a stable floor price of $20 per barrel for new domestic production; (2) provide, through the tax code, incentives for targeted areas such as new field exploration and enhanced oil and gas recovery; or (3) significantly enlarge oil and gas recovery research and development, with special emphasis on those portions of the resource base amenable to near-term pay out.

Floor Price

Current oil prices are nearly $20 per barrel, but the volatility and hence the uncertainty that such a price will persist is substantial. At present exploration and development activity is at a level expected with a firm $15 per barrel. The current volatile price is thus being discounted by 25 percent as far as exploration and development investment is concerned. If the price were stable at $20 per barrel (real term) an additional 300 million barrels a year of reserves would likely be added and early 1990 production would be about 1.2 mmb/d more than if prices at or discounted to $15 per barrel persist.

Tax Code Provisions

A floor price of $20, as critical as it would be, will not stimulate a number of strategic types of reserve replacement. Certain very low risk exploration projects become feasible at $20, but the bulk of large prospects in frontier areas or smaller prospects in onland areas will require incentives beyond the $20 floor price. Also substantial offshore development requiring new production platforms and new investments in enhanced oil and gas recovery will require additional incentives.

A significant incentive would allow domestic geological and geophysical costs to be expended in the same manner as intangible drilling costs. Recovery of much of the remaining oil and gas resource base in the U.S. is dependent on efficiencies that would come from greater geological and geophysical expenditures. Incremental reserve additions of 80 million barrels a year would accrue from this allowance.

Another important incentive would be a comprehensive tax credit that would allow a 5-percent credit for all exploration and drilling expenditures. This would reduce costs and encourage increased oil and gas exploration and development. Such provisions would give an increment of about 130 million barrels of oil reserve additions annually.

A third major incentive would be the restoration of percentage depletion on an unlimited amount of new oil and gas production at a rate of 27.5 percent. This action would result in additional reserves on the order of 145 milion barrels a year over the next five years.

All the above incentives, including the floor price would apply to new production. Some special provisions should apply to existing production that is marginal, such as stripper leases. A credit, say 10 percent, could be allowed for assets placed in service on a stripper well, as well as a similar credit for well workovers. Such action would prevent the loss of an estimated 25 million barrels a year of production at current prices.

The third basic step is a substantial public sector investment in oil and gas research and development. A recent report of the Department of Energy's Energy Research Advisory Board called for an increment of $50 milion this fiscal year and $100 million in FY90. This recommendation, if implemented, would result in a current expenditure of $84 million and an FY90 expenditure of $134 million. My analysis indicates that recovery of oil and gas from the remaining resource base, at given prices, can be increased by factors of 2.5 to 3 if improved efficiencies provided by targeted research can be effected.

VI.

The incremental costs of putting into place the recommendations herein would be about $2.3 billion per year, including about $600 million per year for the floor if a $2 a barrel price below floor price obtains (it is likely that the U.S. floor price would soon become the world price), about $1.6 billion per year in tax revenue lost, and $100 million per year on research. The incremental additions to reserves are estimated to be about 670 million barrels of oil annually and about 160 million barrels of oil equivalent in natural gas. This translates to an incremental cost to the consumer of well under $3 barrel, but does provide incremental reserve addition to keep lower 48 production relatively stable and would permit significant offset of substantial Alaskan decline by encouraging Alaskan development and exploration.

The essential key to adequate domestic production is stable moderate prices and improved efficiencies in discovery and recovery. This can allow the U.S. to enjoy relatively stable domestic production and minimize the chance of future price shocks and supply interruptions.

STATEMENT OF RAYMOND H. HEFNER, CHAIRMAN, INDEPENDENT PETROLEUM PRODUCERS ASSOCIATION OF AMERICA, WASHINGTON, DC

Mr. HEFNER. Thank you, Senator Boren.

I am Raymond Hefner, Chairman of the Independent Petroleum Association of America. I am here today on behalf of the IPPAA and 43 other unaffilliated State and regional independent oil and gas producing associations.

We commend the committee for examining what we believe are extremely important issues to the nation and to the petroleum industry. This industry and the States that depend on it for revenues are going broke. The national and international banking systems are beleaguered as in no time since the great depression.

Last year, 144 banks went under. And the Federal Deposit Insurance Company predicts another 150 will fail this year. The majority of those past and future failures were in principal oil and gas producing States.

I don't think the public really comprehends the severity of this situation, especially from the standpoint of our national security. The Department of Energy has documented and the U.S.S. *Stark* incident in the Persian Gulf has underscored the serious threats to our national energy, military and economic security caused by growing dependence on insecure imported oil.

Mr. Chairman, there is no free market for crude oil as long as the market price for that oil is intentionally manipulated by a handful of foreign producers that have the openly stated purpose of driving out high-cost producers. We cannot rely on that market alone to encourage the domestic drilling that is required for long-term energy security. To compound the problem, tax disincentives in the Internal Revenue Code and misdirected regulatory provisions discourage active exploration.

Since 1976, the alternative minimum tax has prevented active independent producers from fully deducting legitimate costs of doing business. The 1986 Tax Reform Act has exacerbated this problem.

The two most fundamental deductions in exploration and production are intangible drilling costs (IDC) and percentage depletion. Briefly, IDC is the cost of those items which are not salvageable but are necessary for drilling oil and gas wells and preparing them for production. Producers pay hard cash for these items, so 'intangible' is a misnomer to say the least.

The concept of percentage depletion recognizes the economic fact that oil and natural gas are physically depleting assets. Unless producers continually drill for new reserves, they are liquidating their business. These two vital deductions, IDC and percentage depletion, are designated as preference items and, therefore, treated as income when computing alternative minimum tax liability.

The AMT discourages producers to a much greater extent than before from any new exploration and development. Under this minimum tax system, the more active and aggressive a producer is, the more he is penalized by the alternative minimum tax.

Keep in mind that I am not talking about the outside investors and their problems with the AMT, although they may have problems with AMT. Those investors have all but disappeared from oil and gas investments because of the new passive loss rules.

The restructured AMT hits hard many full-time oil and gas explorers, whose only business is finding and producing crude oil and natural gas. These are the people who feel the most severe impact of the AMT.

We believe that an aggressive new energy and tax policy is needed that will, one, encourage the exploration and development of new domestic oil and gas reserves; two, stop the dramatic loss of stripper and marginal production; and, three, maximize existing reserves through enhanced recovery.

Congress should enact into law a new broad-based income tax credit based on a percentage of expenditures necessary to find and develop new reserves, as well as maintain and enhance existing reserves.

Finally, it is very important to keep in mind that none of the tax incentives or changes to the Code will work unless the alternative minimum tax, the AMT, is corrected. There is no stimulant for this industry through the Tax Code without minimum tax relief.

Thank you.

Senator **Boren**. Thank you very much, Mr. Hefner.

Mr. Gibbens, we are glad to have you with us this morning.

[The prepared written statement of Mr. Hefner follows:]

U.S. SENATE
FINANCE SUBCOMMITTEE ON ENERGY AND AGRICULTURE TAXATION
Hearing on Petroleum Industry Taxation
June 5, 1987

I am Raymond H. Hefner, Jr., Chairman of Bonray Energy, an independent oil and gas producer from Oklahoma City. I am here as chairman of the Independent Petroleum Association of America. Together with the 43 unaffiliated state and regional associations listed on the cover page, we represent the estimated 12,000 independent oil and gas producers who account for 90 percent of the wildcat drilling in the United States and 85 percent of all drilling, which results in a majority of the significant oil and gas discoveries. Independents generally have only one profit center --- the sale of oil and natural gas at the wellhead --- and one place for reinvestment of capital, exploration and development of new reserves. They do not refine, transport or market oil and natural gas as a principal business.

Before addressing the specific issues on the committee's agenda, it is appropriate to state some very basic, but frequently overlooked facts about the U.S. energy posture.

First, we are not running out of conventional oil and natural gas reserves. We have more than enough to last well beyond the time when we will make the transition to alternate fuels as primary sources of energy.

Second, we presently have, but are rapidly losing the manpower, equipment, and technology to develop our oil and natural gas resources.

Third, our declining U.S. production is the result of intentional economic terrorism waged against the U.S. by foreign governments, combined with our own misdirected energy tax and regulatory policies.

And lastly, given timely, properly directed action by Congress and the

Administration we can reverse the present situation and regain control of our energy security. Unless this is done we cannot assure our military and economic security.

The Department of Energy has documented, and the USS Stark incident has underscored, the serious threats to our national energy, military, and economic security caused by growing dependence on insecure imported oil. IPAA is urging Congress to initiate aggressive new energy and tax policies to avert the emergencies that could occur if no action is taken. New tax law and energy policies should encourage the long term maintenance, enhancement and replacement of our domestic crude oil and natural gas production and reserves. Existing laws and regulations which penalize individuals and companies that explore for and develop U.S. energy reserves must be eliminated. The infrastructure of the U.S. energy industry and, therefore, our ability to respond to an energy crisis, has been damaged seriously and must be repaired immediately.

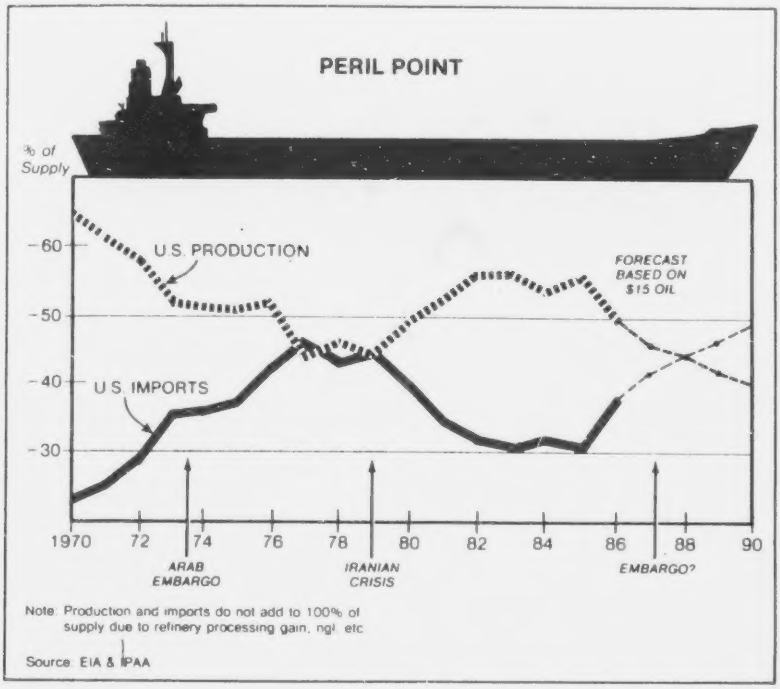
S.233 and S.200 are excellent first steps in reducing our energy dependence. However, the repeal of the windfall profit tax and transfer rules coupled with restoration of the net income limitation on depletion, as recommended by the President, will not stop the flood of imports, nor the decay of U.S. energy productivity. More aggressive measures are needed to provide greater certainty for high-risk investments in the exploration and development of new reserves.

There is no free market for crude oil. As long as the market price for crude oil is manipulated by a handful of foreign producers, we cannot rely on that market to encourage the domestic drilling required for long-term energy security. To compound the problem, tax disincentives in the Internal Revenue Code discourage active exploration. The U.S. must take bold new steps to ensure its long-term security.

Our written testimony before this Committee in January, 1987, set forth the background of our energy security problem. That problem still exists, as the following updated material shows.

Today, U.S. dependence on petroleum imports is increasing at an alarming rate. As shown in Figure 1, our total import dependence is approaching 40 percent.

Figure 1.

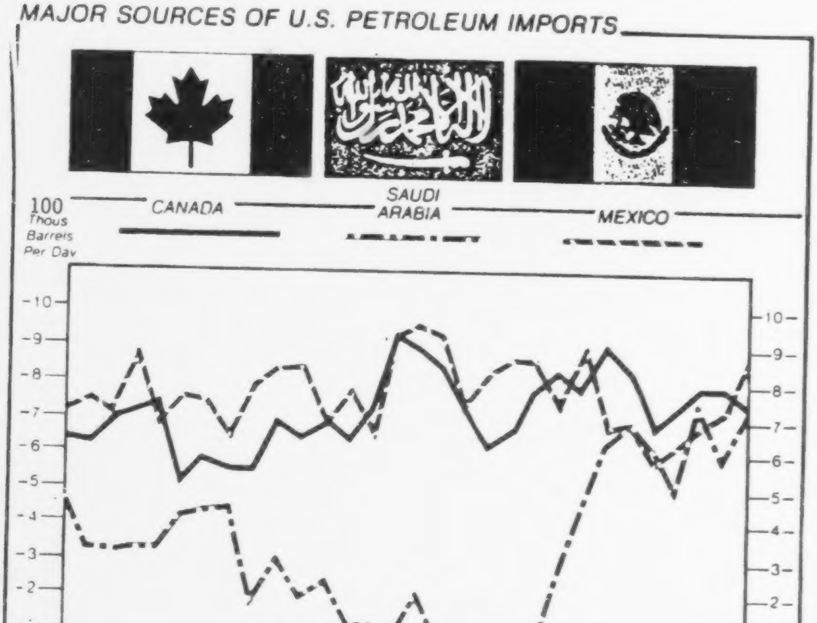


Note: Production and imports do not add to 100% of supply due to refinery processing gain, ngl, etc

Source: EIA & IPAA

Figure 2 shows our sources of petroleum imports also are shifting in a dramatic way. Until recently, most of our imports came from Western Hemisphere nations such as Canada, Mexico, and Venezuela. In 1985, Saudi Arabia ranked seventh on our crude oil import list. In 1986, it moved up to first. In the first quarter of 1987, Saudi Arabia slipped to the second dominant U.S. crude oil supplier with shipments only slightly less than Mexico's. In terms of combined crude oil and products, Saudi Arabia has moved into the number three position in the first quarter of 1987 after ranking fourth in 1986, and eighth during 1985. Some 70 percent of the world's surplus oil producing capacity is in the Persian Gulf and North Africa. Western sources, such as Canada and Mexico, have very limited ability to increase production if Persian Gulf supplies are cut off.

Figure 2.



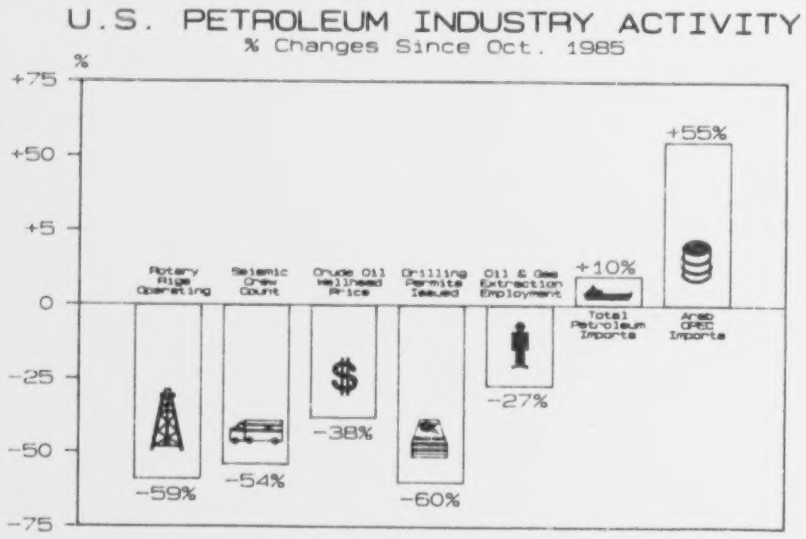
Source Energy Info Admin
Note Data Includes SPR Shipments

IPAA Chart

In the Middle East, the six-year war between Iran and Iraq continues. The U.S. is becoming increasingly involved in this hostile region. If Iran is successful in defeating Iraq, will Iran then mount an offensive against other Arab nations such as Saudia Arabia and Kuwait? Will the entire Persian Gulf, with its dominant world oil reserves, erupt into full scale war? And if this comes to pass, would the United States and the rest of the free world be able to sustain their economic and military strength without petroleum from the Middle East? If the Free World becomes hostage to Middle Eastern events, will the Soviet Union be tempted to exert greater pressure in the region?

What has happened to the domestic petroleum industry? When Saudi Arabia decided in late 1985 to abandon its role as OPEC's swing producer, the already depressed U.S. petroleum industry suffered its worst economic decline in history. Figure 3 compares the latest available monthly industry data with that of October, 1985, just before OPEC declared its change in strategy to one of increasing market share rather than supporting prices.

Figure 3.



IPAA Chart
April 1987

The glut of petroleum supplies on the world market caused average U.S. wellhead crude oil prices to drop from $24 per barrel in October, 1985, to less than $11 per barrel a year later. Although domestic prices have climbed back above $15 per barrel, they remain nearly 40 percent below the October, 1985, level. Investment in maintaining, enhancing, and finding new reserves is far from economic.

The number of seismic crews scouting for potential drilling sites has declined 54 percent, from an average of 357 crew-months in October, 1985, to 164 in April, 1987. The number of drilling permits issued has dropped off 60 percent during the same period --- from 6,606 to 2,616.

The most familiar indicator, the Baker-Hughes rotary rig count, reached its lowest recorded level in July, 1986. It has fallen 59 percent --- from 1,879 rigs operating in October, 1985, to an average of 763 in May, 1987.

Turning to the employment picture, 154,300 persons have lost their jobs since October, 1985, in the oil and gas extraction phase of the industry. This is a 27 percent drop, with the total employed declining to 416,400 in April, 1987. This figure only accounts for one sector of the domestic petroleum industry and does not tell the full story. For example, employment in the oil and gas services sector of the industry dropped from 316,100 in October, 1985, to 202,800 in March, 1987 --- a 36 percent decline. These figures do not measure the total long-and short-term damage to the overall U.S. economy that occurs from record bankruptcies, bank failures, and reductions in capital expenditures.

As domestic production declines, petroleum imports continue to rise. Total crude and product imports are up 10 percent since October, 1985, to an average of nearly 5.6 million barrels per day.

From the late 1960s through the Tax Reform Act of 1986, it has been fashionable politically to target crude oil and natural gas producers with every new energy or tax law or new regulation.

During the 1970s the price of domestic crude oil was held below world market prices. Domestic producers sold some domestic crude oil for as much as $26 per barrel below the price paid for imported oil.

When crude oil prices finally were decontrolled, Congress passed the ill-named Crude Oil Windfall Profit Tax Act of 1980 --- a tax designed to deprive domestic crude oil producers of the same wellhead revenues that other oil producers in the world had been receiving throughout the decade. Approximately $78 billion in revenues that domestic producers could have reinvested in the search for more U.S. reserves were diverted to the U.S. Treasury. Most of the serious proposals now being considered by Congress to stimulate petroleum exploration would cost less than 10 percent of the amount taken from our industry by the windfall profit tax.

Since the mid-1970s, percentage depletion has been reduced for independent producers and eliminated for others.

Last year, Congress adopted new "passive loss" rules which have limited severely the availability of essential "outside" capital. In addition, the Tax Reform Act of 1986 restructured the alternative minimum tax (AMT) so that active independent operators cannot fully deduct legitimate costs of doing business.

The two most fundamental deductions in exploration and production are intangible drilling costs (IDC) and percentage depletion. Briefly, IDC is the cost of those items such as wages, fuel, supplies and payments to outside contractors which have no salvage value but are necessary for the drilling and preparation for production of oil and natural gas wells. Producers pay hard dollars for these items, therefore, "intangible" is a misnomer.

The concept of percentage depletion recognizes the economic fact that oil and natural gas are physically depleting assets. Unless producers continually invest funds in drilling for new reserves, they are liquidating their businesses. Also, producers must use cash flow from successful wells to pay for both those wells and the dry holes. Depletion also recognizes the economic fact that over time, the cost of reserve replacement increases dramatically. In addition to oil and natural gas, more than 100 minerals including uranium, gold, silver, copper, tin, zinc, gravel, and coal are entitled to percentage depletion.

These two vital deductions, IDC and percentage depletion, are designated as "preference items" (i.e. "penalty" items) and therefore treated as "income" when computing alternative minimum tax liability.

In this way the new AMT discourages producers from new exploration and development. Under the current minimum tax system, the more active and aggressive a producer is, the more he is penalized by the alternative minimum tax.

Keep in mind, we're not talking about outside investors. They have been discouraged from oil and gas investment by the new passive loss rules. We're speaking of many full-time oil and gas explorers whose only business is finding and producing crude oil and natural gas. These are the people who feel the true impact of the AMT. IPAA believes that 70-80 percent of the active independents will pay alternative minimum tax in 1987 due to the anomaly just described.

Independent producers are not opposed to the concept of the minimum tax. They are, however, opposed to paying minimum tax on the costs of finding (IDC) and developing (depletion) crude oil and natural gas reserves. Any changes in the tax code which are enacted to encourage domestic oil and gas activity must correct the minimum tax structure. Without such a change in the minimum tax, using the tax code to encourage increased exploration and development will not work.

There seems to be a factual misunderstanding by some about an important aspect of petroleum exploration and development that needs clarification. The Joint Committee on Taxation analysis of the proposals under consideration indicates that geological and geophysical activities (G&G) are methods of exploration which are alternatives to exploratory drilling. That is incorrect. Both are required. They are like the two halves of a pair of pliers - neither will work without the other. While G&G can significantly increase the prospects for the success of a wildcat well, it alone cannot determine the existence of petroleum reserves in the earth. Only the drilling of a well can accomplish that fact which is the indispensable step in creating new oil and natural gas production. Expenditures for both G&G and IDC should be currently expensed and not treated as "income" for AMT purposes.

CONCLUSION

IPAA believes that an aggressive new energy and tax policy is needed. The tax code is an appropriate, effective, and the least costly vehicle for encouraging domestic exploration and production. This policy must be designed to:

- encourage the exploration for and development of new domestic oil and gas reserves;
- stop the dramatic loss of stripper and marginal production; and
- maximize existing reserves through enhanced recovery.

Exploration and Development

Cash actually spent to drill an oil or gas well (IDC) should not be treated as income when computing the alternative minimum tax. Percentage depletion, should not be treated as income when computing alternative minimum tax liability. These two "preference items", plus other limitations, significantly discourage new drilling. To encourage new exploration and development activity, a portion of such expenditures should be used to offset either regular income tax or alternative minimum tax liability.

We recommend:

A. that a certain percentage of the expenditures for new exploration and development be treated as a payment of, and therefore, a credit against, either regular or alternative minimum tax liability;

B. that expenditures for exploration and development of new wells not be treated as an alternative minimum tax "preference item"; and

C. that geological and geophysical expenditures be treated the same as other exploration and development expenditures.

Stripper Wells and Other Marginal Production

Stripper production accounts for 15 percent of total U.S. crude oil production; approximately 1.3 million barrels per day in 1985. The Department of Energy estimates that if crude oil prices stay within the $15-20 range the U.S. will lose approximately one-half of its stripper production. In 1986 alone the Interstate Oil Compact Commission estimates that 307,000 barrels per day of stripper production was either permanently or temporarily lost. To save this production and the underlying reserves, producers must be allowed to reduce their operating costs. We recommend:

A. that a percentage of operating and maintenance costs of oil and gas stripper wells, marginal wells, and heavy crude oil wells be treated as a payment of, and therefore, a credit against either regular or alternative minimum tax liability; and

B. repeal the 50 percent of net income limitation and the 65 percent of taxable income limitation on percentage depletion.

Enhanced Recovery

America's most readily available and abundant source of new production is through enhanced recovery from already discovered reservoirs. Billions of barrels of additional domestic reserves are available through secondary and tertiary production techniques. Aggressive measures should be taken to encourage initiation of new enhanced recovery projects. We recommend:

A. that a percentage of expenditures for initiating, expanding, or implementing secondary and tertiary enhanced recovery projects be treated as a payment of, and therefore, a credit against, either regular or alternative minimum tax liability; and

B. that the existing research and experimentation tax credit be clarified to include expenses for new and innovative methods of extracting oil and gas reserves.

Additional Steps Required

America's military, financial, and economic well-being relies on a healthy domestic oil and gas industry. While the above recommended actions will do much to help revitalize domestic petroleum exploration and development, other steps are necessary. In the area of tax code changes, at a minimum, the following changes should be made. We recommend:

A. that the transfer rules for both percentage depletion and windfall profit tax be repealed;

B. that the windfall profit tax be repealed;

C. that the Section 29, nonconventional fuel credit, be maintained and broadened; and

D. that the double tax detriment of using one tax preference item to compute another tax preference item be eliminated.

Extraordinary Actions

The dominant Middle East OPEC countries continue to hold oil prices below the level needed for the United States to maintain adequate reserves of oil and gas. We ask the Congress and the President to take all appropriate actions to prevent OPEC control of our energy supplies and urge the use, whenever needed, of two actions specifically approved by the IPAA:

o a floor price for crude oil to provide stability; and

- a variable import fee on crude oil and petroleum products, without exceptions or exemptions, to stabilize the price of domestic crude oil and products at an adequate level.

Secretary of Energy John Herrington stated recently, "...our economic and energy security is inextricably tied to the fate and fortunes of our domestic petroleum industry through this century." Our national security demands that the rising level of imports be stopped. A revitalized U.S. oil and gas industry, with adequate and stable prices, is the key to winning this battle.

STATEMENT OF WAYNE GIBBENS, PRESIDENT, MID-CONTINENT OIL AND GAS ASSOCIATION, WASHINGTON, DC

Mr. GIBBENS. Thank you, Mr. Chairman.

Mr. Chairman, by now it is well documented that declining U.S. oil and gas development and the rising level of oil imports constitute a serious threat to America's energy and national security. In an effort to help the committee deal with that threat, the Mid-Continent Oil and Gas Association and the American Petroleum Institute have jointly submitted a statement for the record. It suggests some responses aimed at reversing the trend toward diminished domestic production and increased reliance on imports.

In my time that I am permitted this morning I will speak to one of those recommendations: The importance that the Petroleum industry attaches to the repeal of the misnamed and misguided windfall profits tax. Misnamed because, in fact, the tax bears no relationship whatever to a producer's profit or loss. Rather, it is an excise tax determined solely by price.

Misguided because it is bad tax policy and bad energy policy that serves as a deterent to increased domestic oil and gas development.

Since the tax has not been collected since the beginning of 1986 because oil prices have been below the base price levels where the tax is imposed, the question arises: Why is the industry so concerned about an inactive tax? Well, the reason is that with domestic production down 8 percent from last year, with demand up 3 percent, with imports up by nearly 25 percent, and imports from the dangerously unstabled Persian Gulf up by nearly 200 percent, it is clearly in our national interest to increase domestic oil and gas production. And, Mr. Chairman, the windfall profits tax stands directly in the way of that objective.

For example, Tier 1, or old oil is a primary target of the windfall profits tax. Any time the price rises above $18.97, the windfall tax would be reactivated and oil producers would be required to pay 50 to 70 percent of the increase to the government.

May I emphasize here—it was said earlier this morning—that no other industries are required to pay 70 percent of their profits to the government. It is not 70 percent of profits, it is 70 percent of the gross above the base price, and that should not be viewed in isolation. Combine that 70 percent of the gross above that base with severance taxes, State and local taxes, and ordinary income taxes, and the producer is left with 13, 14, 15 cents. That is a steep tax by any standard. And it is a disincentive targeted exactly where America does most of its drilling and finds most of its productive wells.

Last month, the Petroleum Industry Research Foundation released an outstanding study and I would like to have it included in the record, Mr. Chairman.

Senator BOREN. It will be so included.

Mr. GIBBENS. Thank you.

[The study follows:]

Petroleum Industry Research Foundation, Inc.

I. OVERVIEW

A. Introduction

There is currently a debate over maintaining or abolishing the Windfall Profit Tax (WPT) on U.S. crude oil production, an excise tax imposed by Congress in March 1980. President Carter, who had proposed the WPT, described it as "the largest tax ever levied on any industry in the history of the world," yet no payments have been due since the beginning of 1986 because oil prices since then have been consistently below the thresholds which activate the WPT.

However, the current debate is more than an academic exercise over whether to maintain an inactive special tax on the oil producing industry. The price of crude oil in the U.S. outside of Alaska, (the so-called "lower-48 region") has recently moved quite close to the $19/bbl base price in the Tier One category of the WPT. Any increase over this base price would reactivate the tax, requiring oil producers to pay 50%-70% of the increase to the government, making the latter the principal beneficiary of the increase. Currently, 2.0-2.5 million B/D, or about one third of lower-48 crude production, is in this Tier One category.

The Windfall Profit Tax, which despite its name is a function of price and not of the producer's profit or loss, had not lived up even before the price collapse of 1986 to the revenue projections calculated at the time of its passage. For the period 1980-85 the projection was for a gross tax collection of $170 billion. Actually only $78 billion were collected during this period.

The discrepency reflects the sharp contrast between the expectation and the reality of world oil prices in the post-1981 period. The expectation was that OPEC would be able to raise prices faster than the U.S. inflation rate throughout the 1980's. Part of the cartel-enforced price increase, it was argued, should go to the Treasury. The reality was that world oil prices peaked in 1981 and have declined in every year since. Not surprisingly, WPT collections followed the same pattern as the oil prices. So did U.S. oil and gas drilling activities which peaked in 1981 at an annual rate of nearly 4,000 active rigs, dropping to just under 2,000 by 1985 and to less than 1,000 in 1986. Given the observed close relationship between drilling activities and oil prices, it is reasonable to assume that any oil price increase at this time would bring about a growth in drilling activities. The question then is whether reactivation of the WPT would inhibit this growth and, if so, whether this would be counter to the public interest.

B. The Debate

The advocates for ending the WPT include the Administration, legislators from the oil producing states as well as some law makers, public opinion leaders and academics outside the "oil patch" or the oil business. Their principal arguments are as follows:

> -What "windfall"? World oil prices have fallen so low and the oil producing industry's economic state has been so bad for the past 18 months that there is no justification to continue singling this industry out for a special excise tax which was passed at a time when prices were substantially higher and were expected to keep rising in real terms.

-**Development drilling is vulnerable.** Development and extension wells drilled into Tier One property (where there was commercial production prior to 1979) will result in production subject to the WPT. Since development and extension wells lead to a larger share of U.S. reserve additions, overall, than wildcat exploratory wells, the U.S. cannot afford to impair the economics of development drilling.

-**The WPT's drain on cash flow will hamper exploration.** Since the low price environment has constrained the industry's access to capital, the need to finance exploration activity out of cash flow is critical. Taxing away up to 70% of incremental unit revenue, even if only applied to Tier One volumes, reduces the cash flow available for this purpose.

-**Only a price increase will brake the U.S. production decline.** In 1986, production decreased by about 700,000 B/D between the first and the fourth quarter. Price uncertainty and prices too low to justify drilling and support maintenance activities were generally the major factors. Thus, to stop or at least slow down the decline in oil production requires an increase in oil prices from the present level. Hence any reasonable price increase should not be largely offset by the WPT.

-**The accelerated production decline since 1986 is not in the national interest.** A recent study by the U.S. Department of Energy, whose findings were endorsed by the White House, pointed to the national security threat of the resulting inexorable increase in U.S. dependency on imported oil. The study found that if prices did not rise significantly and no other measures were taken, the decline in production would continue at an undesirable rate.

Of course, advocates for continuing the WPT have their own arguments which are summarized below, together with the relevant counter-arguments:

-**A deal's a deal.** A bargain was made in 1980 under which all price control on domestic oil would be removed in return for a WPT on the resulting price increase. There is no justification now to abrogate the side of this bargain which made decontrol politically acceptable at the time. (The counter-argument is that a law based on a specific set of circumstances and assumptions can and should be reviewed and altered when the circumstances have basically changed and the assumptions proven wrong.)

-The threshold price for newly discovered oil is too high to affect exploration activities. The world oil price will likely not exceed the Tier Three base -- now about $28.50 and scheduled to rise 2% faster than inflation -- before WPT enters its statutory phase-out period, January 1991 to September 1993. (The counter-argument: more oil is found through revisions and extensions than through new discoveries. Increases in development and extension drilling in response to a price rise will be inhibited if the WPT is reactivated for Tier One production.)

-The Tier One threshold is above the cost of production. With the lowest Tier's threshold at $19 and remaining constant in real terms, the cost of production on all flowing volumes is well below the level where the WPT could have an effect. (The counter-argument: True, flowing production would not be affected by the WPT. However flowing oil wells deplete naturally and must be continuously replaced by new development wells. The latter, as pointed out, would be affected by a tax on Tier One production.)

-The budget deficit is too large to remove any potential source of revenue. The budget deficit is an on-going burden to the economy. With few options for reducing it, discarding a revenue source already in place would be irresponsible. (The counter-argument: This is no justification for taxing one industry more than others when all initial reasons for this special treatment have ceased to exist.)

Whatever the validity of both sides' arguments and counter-arguments, one fact is indisputable: U.S. oil production dropped by some 700,000 B/D between the first and the fourth quarter of 1986 (more than 300,000 B/D on average from 1985 to 1986) and will drop another 300-350,000 B/D this year. These declines are due primarily to the very sharp drop in oil drilling activities which was the direct result of the price collapse. The number of active rotary rigs averaged 964 in 1986, and in the first quarter of 1987 has averaged about 800.

The production declines and prospects of continuing increases in import dependency, combined with the very low level of drilling activity and its drain on the upstream support industry, have given rise to renewed concerns over the role of energy in national security. The recent Department of Energy report, Energy Security, has led the Administration to the conclusion that increased imports carry a security penalty. It follows then that domestic upstream activity should be aggressively pursued. But a tax policy specifically designed to blunt the incentive of an oil price increase by channelling a large part of it into the U.S. Treasury is in conflict with this conclusion. Removal of the WPT, furthermore, will not introduce a skew into investment decisions but rather will remove an impediment, allowing investment to move more freely than is now the case.

Another fact is that the proponents and supporters of the WPT in early 1980 did not believe that the price of oil could move like that of any other commodity, that is, fall as well as rise, collapse as well as soar. Now that this basic assumption underlying the WPT has proved to be incorrect, the need and justification for this unique form of taxation of a domestic natural resource should be re-examined in the light of the knowledge gained since 1980.

II. HISTORY, STRUCTURE AND RATES

The WPT was initially proposed by President Jimmy Carter in April 1979, as part of his phased crude oil decontrol program. Congress passed the tax in March 1980. Between April 1979 and March 1980, the price for imported crude oil delivered to U. S. refiners nearly doubled, rising from about $17.50 to about $33.50. These prices reflected the combination of temporary supply shortages and OPEC's control of the market. Uncontrolled domestic crude oil prices, such as those for stripper well oil, rose even more rapidly. Oil company profits appeared particularly large at the time as well, since they were swollen with inventory gains. The high profits, however, did not continue, especially for integrated companies. The WPT, then, was passed against a backdrop of soaring prices and, it seemed, endless high profits. The WPT, however, does not address the issue of profit and loss in the calculation. The tax is solely an excise.

A. The Tiers and Tax Rates

The WPT divides oil production into three "Tiers," depending on the date of initial production and other specified characteristics. Tier One includes oil that was formerly under price control; its commercial production commenced prior to 1979. Tier Two includes stripper well oil and production from the Naval Petroleum Reserve. Tier Three includes oil discovered (or developed) after 1978, incremental tertiary volumes, and heavy oil. Each tier has a different tax rate and a different threshold price.

The law differentiates between integrated and non-integrated ("independent") producers; independents pay a lower rate on the first 1,000 barrels/day of their production. (See Tables I and II.)

Tier One oil taxed at 70% (integrated production and independent production over 1,000 B/D) constitutes the largest category of taxed oil.

TABLE I

TAX RATES UNDER THE WINDFALL PROFIT TAX

	Integrated Producer	Independent Producer
Tier One		
Oil from reservoirs discovered and developed before 1979	70.0%	50.0%
Tier Two		
Oil from stripper wells and the Naval Petroleum Reserve	60.0%	30.0%*
Tier Three		
Newly discovered oil--oil discovered and developed after 1978**	22.5%	22.5%
Incremental tertiary oil	30.0%	30.0%
Heavy oil	30.0%	30.0%

*Independent stripper well oil exempt beginning in 1983.
**Taxed at 30% from 1980 through 1981, 27.5% in 1982, 25% in 1983, and 22.5% beginning in 1984.

TABLE II

VOLUMES OF OIL SUBJECT TO THE WINDFALL PROFIT TAX, 1981 AND 1985

	1981		1985	
	Volume (MB/D)	%	Volume (MB/D)	%
Tier One (excl. Sadlerochit*)				
Taxed at 70%	3364	47.5	2487	44.6
Taxed at 50%	319	4.5	215	3.9
Tier One (Sadlerochit)				
Taxed at 70%	1290	18.2	259	4.6
Taxed at 50%	3	-	0	0
Tier Two				
Taxed at 60%	586	8.3	542	9.7
Taxed at 30%**	343	4.8	27	0.5
Tier Three				
Newly discovered	800	11.3	1173	21.0
Incremental tertiary	45	0.6	527	9.4
Heavy oil	327	4.6	348	6.2
Total	7077	100.0	5578	100.0

*Oil from the Sadlerchit reservoir in Alaska's Prudhoe Bay field is treated separately because of high transportation costs.
**Independent stripper oil exempt beginning in 1983.
Source: Internal Revenue Service. Volumes represent taxable oil only, as reported on tax returns specifying volumes.

The taxable "windfall profit" is the difference between a defined base price (see below) and the "removal price" (the producer's selling price). The taxable "windfall profit" is reduced by increases in state severance taxes due to the higher "windfall" prices. Hence, the taxable amount is equal to:

RP - (ABP + SST), where
RP is the removal price, read "selling price;"
ABP is the adjusted base price, read "threshold;"
SST is the state severance tax adjustment, the increase in severance taxes due to the higher price.

B. Base Prices

The base price (threshold) for Tier One was set by Congress as the property's "upper tier" price as of May 1979 under the price control system, reduced by $0.21/bbl. The nationwide average upper tier price was $13.02/barrel in May 1979; the average base price for Tier One under the WPT is thus $12.81. Base prices are adjusted for inflation (the GNP price deflator) in each quarter. The cumulative inflation adjustment since the inception of the tax has been nearly 50% (.4807) to the 2nd quarter 1987. The current average base price is $18.97.

The base price for Tier Two was set at $15.20, to be adjusted for quality and location based on the relationships prevailing, on a percentage basis, in December 1979. Escalated by the GNP price deflator, the 2nd quarter 1987 average Tier Two base price is $22.51/bbl.

The base price for Tier Three was set at $16.55, to approximate the free market domestic price in May 1979. It too is adjusted for quality and location based on December 1979 relationships. Since Tier Three includes newly discovered oil as well as volumes which are expensive to produce, the base price escalates faster than inflation to lessen the tax's disincentive. Equal to the GNP price deflator plus 2% per year, the cumulative Tier Three inflation-plus adjustment has reached nearly 72% by the 2nd quarter 1987; the current average adjusted base price is thus $28.46.

As shown in Table III, average wellhead prices in the Lower-48 states fell below the average Tier Three threshold in mid-1985. There would not have been taxes due on most Tier Three volumes in 1986 even in the absence of the 1986 price collapse. In 1986, even the Tier One threshold--the May 1979 controlled price adjusted for inflation--was above the average wellhead price by as much as $6-7/bbl, or 50%.

C. Exempt Oil

Some categories of oil are statutorily exempt from the WPT: oil produced from economic interests held by state and local government, charities, Indian tribes and individuals, certain stripper well oil, certain Alaskan oil and certain royalty oil.

Stripper well oil produced by an independent is exempt, subject to several conditions. The most stringent of these is that the property cannot have been transferred from a non-independent owner after July 1981. (The President has suggested in his recent Message to Congress that this restriction be eliminated.) Hence, the volume data shown in Table II include a

TABLE III

WINDFALL PROFIT TAX ADJUSTED BASE PRICES AND AVERAGE WELLHEAD PRICES IN THE LOWER-48

($/bbl)

	Adjusted Base Prices			Wellhead
	Tier One	Tier Two	Tier Three	Lower-48
May 1979	12.81	15.20	16.55	NA
Average Annual*				
1980	13.51	16.03	17.68	22.68**
1981	14.72	17.46	19.64	33.71
1982	15.95	18.92	21.72	30.43
1983	16.76	19.88	23.27	28.00
Quarterly				
1984 1st Q	17.12	20.31	24.07	27.74
2nd Q	17.31	20.54	24.48	27.76
3rd Q	17.45	20.71	24.79	27.78
4th Q	17.60	20.88	25.12	27.09
1985 1st Q	17.76	21.08	25.48	25.58
2nd Q	17.90	21.23	25.80	25.80
3rd Q	18.14	21.52	26.29	25.63
4th Q	18.25	21.66	26.58	25.94
1986 1st Q	18.35	21.78	26.86	19.48
2nd Q	18.61	22.08	27.37	12.20
3rd Q	18.72	22.21	27.67	11.67
4th Q	18.80	22.31	27.93	12.77
1987 1st Q	18.93	22.47	28.27	NA
2nd Q	18.97	22.51	28.46	NA

*For adjusted base prices, annual figures are the arithmetic average of quarterly numbers, shown for illustration. Windfall profit taxes, however, are only based on quarterly calculations.

**Includes price controlled and decontrolled volumes.

Sources: Based on data from the Internal Revenue Service and U.S. Department of Energy.

small amount of stripper well oil taxed at the lower, independents', rate.

The exemption for Alaskan oil was aimed at high-cost, undeveloped production. North of the Arctic Circle, only Prudhoe Bay production from the Sadlerochit reservoir is subject to the tax. Volumes from the Kuparuk unit and from the Lisburne formation were specifically intended to be exempt. Certain volumes south of the Arctic Circle would also be exempt if they were discovered and produced. A significant but unsuccessful court challenge to the WPT was grounded in this geographical bias. The U.S. Supreme Court upheld the tax's constitutionality in a mid-1983 decision.

Also exempt are limited volumes of royalty oil: 2 B/D in 1985. The law had initially allowed royalty owners' a tax credit of $1,000 in 1980 and $2,500 in 1981. The Economic Recovery Tax Act of 1981 changed the provision to a volumetric exemption. The exemption is currently 3 B/D.

III. COLLECTIONS AND GOVERNMENT REVENUE

As noted earlier, annual collections under the WPT peaked in 1981, its first full calendar year, at $26 billion. In that year, the average tax per barrel was $9.07. In 1985, the calendar year collections were $5.6 billion, an average of $2.90/bbl. (See Tables IV and V.)

Revenues fell far short of expectations. At the time the tax was passed, revenue projections had been based on a price which would have risen 2% per year in real terms. Instead, the gradual erosion of the 1981 price peak resulted in a 4th

TABLE IV

CALENDAR YEAR TOTAL WPT TAX LIABILITY*

	Millions of dollars
1980 (Mar-Dec)	9925
1981	25944
1982	16754
1983	10668
1984	8871
1985	5595
Cumulative	77757

*Includes adjustments in each period for overpayments and errors in prior periods. Data do not reflect the reduction in government revenue from lower income taxes.

Source: Internal Revenue Service.

TABLE V

AVERAGE TAX LIABILITY, BY TIER, 1981 AND 1985

($/barrel)

	1981	1985
Tier One (ex Sadlerochit)		
Taxed at 70%	12.78	5.49
Taxed at 50%	9.28	3.84
Tier One (Sadlerochit)		
Taxed at 70%	5.13	.19
Taxed at 50%	8.86	.00
Tier Two		
Taxed at 60%	9.43	2.61
Taxed at 30%	4.87	2.03
Tier Three		
Newly discovered	4.18	.06
Incremental tertiary	3.69	.14
Heavy oil	2.59	.05
Total	9.07	2.90

Source: Internal Revenue Service.

quarter 1985 price which was about 5% lower in real terms than the early 1979 free market price had been. By end-'86, the wellhead price was about half of that early 1979 price.

The WPT is deductible against income for income tax purposes, substantially reducing the net effect of the tax on oil producers as well as on the Federal budget. As shown in Table VI, the net WPT was projected to amount to almost $100 billion in the fiscal years 1980-85, about 60% of gross collections. Instead, the net WPT was less than $40 billion. The WPT's 33-month phase-out was to have been triggered by net collections reaching $227 billion, a level that will not now be reached. Under the statutory alternative, the phase-out will begin in January 1991.

TABLE VI

PROJECTED AND ACTUAL NET BUDGET REVENUES UNDER THE WINDFALL PROFIT TAX, 1980-1985

(Billion dollars)

FY:	1980	1981	1982	1983	1984	1985	Cumulative
Projected*							
Gross WPT	5.2	21.0	32.3	35.1	37.4	39.5	170.5
Change in Income Tax	-2.0	-7.5	-12.7	-15.2	-16.3	-17.3	-71.0
Net WPT	3.2	13.4	19.5	20.0	21.1	22.2	99.5
Actual							
Gross WPT**	6.4	21.4	17.1	10.7	8.0	5.7	69.4
Change in Income Tax	-2.4	-8.5	-7.9	-5.1	-3.6	-2.6	-29.9
Net WPT	4.1	12.9	9.2	5.7	4.4	3.1	39.4

Note: Figures may not add due to rounding.

* Projected by the Conference Committee on H.R. 3919, Crude Oil Windfall Profit Tax Act of 1980, March 1980.

** Excludes receipts from Federal interests and refunds/credits from overpayments.

Source for actual data: U.S. Department of the Treasury.

IV. THE TAX'S EFFECT

As shown above, the WPT on Tier One oil will take up to 70% of any price increase. The argument goes--incorrectly, as pointed out earlier--that the WPT will not impair drilling activity, because the threshold for newly discovered (Tier Three) oil is about $10/barrel above prevailing prices. The argument ignores development drilling.

Development drilling accounts for more than 80% of all wells drilled in the U.S., and for more than 90% of the productive wells (those that find oil or gas). Development wells by definition pierce a productive reservoir. Development drilling can lead to substantial revisions in previous estimates of proven reserves (and have), but the drilling is focussed on additional production, not reserves. The WPT, taking up to 70% of incremental revenue, will clearly hamper the economics of drilling in any Tier One property. Since development drilling in older fields would have been the first to begin again, the tax will limit the relief which the drilling sector will get from rising prices. Production will be dampened in turn by the lack of development drilling.

The argument also ignores extension, or step-out, wells. These exploratory wells are drilled just beyond the known boundary of a proved reservoir. Since the WPT is calculated on a property-by-property basis, these, too, may result in Tier One production, depending on the vintage of the proved reservoir.

Over the period 1979-85, the combination of revisions, improved recovery, and extensions accounted for almost 90% of the additions to proved crude oil reserves in the U.S.* Put another way, drilling in older reservoirs was by far more important to the U.S. reserve position than new discoveries. Thus it is a fallacy that at existing and foreseeable prices drilling activity leads only to production unaffected by the tax, or that the vulnerable drilling activity is unimportant because it is not the risky new field wildcat.

The WPT, as noted earlier, also limits the cash available for exploratory activity. The industry has traditionally reinvested the vast majority of its upstream cash flow in exploratory and production activity. In the period 1981-85, according to an Arthur Andersen & Co. compilation of information from 375 publicly traded companies, the petroleum industry plowed 70% of its production revenue back into upstream activity. The smaller "independent" companies in the sample, furthermore, financed drilling with debt, so expenditures exceeded production revenue. The price declines were particularly difficult for these companies, as interest and principal payments remained unchanged while unit revenues plummeted.

Payments under the WPT will inhibit actual investments in exploratory and development activity because companies do not have cash and will keep straitened companies weak while they struggle to pay down debt. Outside financing, in contrast to the early 1980's, will be largely unavailable, as a consequence of changes in the income tax laws and the new fundamentals of exploration economics. Furthermore, investors are concerned that the tax will not follow its statutory phase-out because rising prices in the 1990's will prove too much of a temptation for Congress, which will extend the date of expiration. At the margin, this concern is one more risk, an additional deterrent for companies investing now in projects with the 6- to 7-year lead time common for exploration projects.

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*Some improved recovery may qualify as Tier Three production under the WPT (tertiary recovery techniques).

Mr. Gibbens. The study points out that that development drilling accounts for more than 80 percent of all wells drilled in the United States and 90 percent of the productive wells. In many respects, it can be said that drilling in older reservoirs is more important to the U.S. reserve position than new discoveries.

Most of the oil discovered through development drilling will be Tier 1 and the windfall tax bite will be enormous. By repealing the windfall profit tax we would stimulate development and extension drilling, put people back to work, add to our reserves, and strengthen our national security. And there is another important factor, Mr. Chairman.

As you are well aware, even in today's economy it takes a lot of money to drill for oil and gas. Traditionally, the industry has reinvested most of its upstream cash flow in exploratory and production activity. That cash flow is needed to reverse the dangerous trend toward dependence, and much of it comes from tier oil.

It has been mentioned that the windfall tax carries an enormous administrative cost. The American Petroleum Institute recently did a study that concluded that cost to the industry is $100 million a year. We have heard the Treasury Department say that the cost to government is $15 million a year.

This is a $100 million burden on the industry when we can least afford it.

Finally, Mr. Chairman, there can no longer be any doubt that the windfall tax is a legacy from an era of wildly misguided perceptions. When the windfall profit tax was enacted, the expectation was that prices were on an infinite escalator. Few people were willing to believe that prices could collapse as well as rise. In fact, as you know, prices have been declining since 1981.

Today, the notion of windfall profits is ludicrous. They don't exist. And it is time we adjusted our tax policy accordingly.

On behalf of America's oil and gas producers, Mr. Chairman, I urge that this committee move promptly toward repeal of the windfall profits tax.

Senator Boren. Thank you very much, Mr. Gibbens.

And now we will hear from Mr. Cummings. We are very glad to have you with us.

STATEMENT OF JAMES R. CUMMINGS, PARTNER, DELOITTE, HASKINS & SELLS, DENVER, CO

Mr. Cummings. Thank you, Mr. Chairman, Senators.

I am national energy director for my firm, Deloitte, Haskins & Sells, and as such, I serve and I have contact with a number of the nation's independent oil companies.

Your efforts to lessen the nation's dangerously increasing dependence on imported oil by encouraging domestic production should really be applauded by all Americans because all of us will ultimately feel the adverse effects of increasing imports.

The principal point that I would like to make today is that without changes in the biggest disincentive—that is, the alternative minimum tax—neither current deductions nor increased deductions will accomplish the objectives of increased exploration or decreased shut down of marginal property.

Specifically, the proposal to increase depletion deductions, while helpful, will not be an effective stimulant without changes in the alternative minimum tax. Although it is too early to tell precisely, I believe that a majority of active independent oil and gas explorers will be in an alternative minimum tax in the future. This is because the primary tax deductions in this industry are treated as preference items, which are not deductible for the alternative minimum tax.

The preferences on depletion, IDC, depreciation of equipment and in some cases the book tax income preference all combine to create traps for the unwary and serious disincentives for the wary. The 1986 Act has magnified these problems.

I have included in my written comments several examples which will demonstrate some of this. A couple of the examples demonstrate that increases in depletion or increases in IDC for a particular taxpayer may result in zero benefit. One of the examples, example 2, shows that where a taxpayer is subject to the depletion and IDC preference, we have one preference determining another preference, that is, depletion helps determine the preference on IDC. And what it results in, is a deduction being taxed. That is, an increase in depletion will actually result in an increase in the alternative minimum tax rather than no benefit or a decrease in tax.

A further example shows that even though taxpayers have an option of capitalizing IDC, there can be some traps there, and they can, in effect, by capitalizing IDC, use up some depletion without getting any benefit of that extra depletion that was used up. And if it was carried forward to a future year, they might get some benefit.

I understand that changes in the AMT tax structure will be difficult because of the perception that tax reform is being re-opened and because of budgetary problems and restraints. However, difficult problems sometimes demand that difficult decisions be made. And I believe that increased dependence on imported oil is one of our biggest problems.

In addition, I do not believe removing disincentives from the oil industry, which decrease oil industry taxes, or rather I do believe that these decreases should be viewed really as a partial refund to the $78 billion of windfall profits tax that has been collected over the past several years. This tax was collected even though history has proved that despite the large temporary increase in prices, the windfall, if any, has been greatly decreased when several years are considered together.

If depletion changes are to occur, to be effective they should be coupled with changes in the AMT as well as changes in other areas, such as the 65 and 50 percent limits.

A couple of final points. I believe that a credit for exploratory and marginal well expenses would be a much better and faster way than any of the other proposals in slowing the decrease in domestic production.

The CHAIRMAN. Would you repeat that again, please?

Mr. CUMMINGS. I believe that a credit for exploratory and marginal well expenditures would be a much better and faster way of slowing the decrease in domestic production.

Now to be effective, such credit would have to be credited against the AMT, against the alternative minimum tax.

Finally, I strongly support the repeal of the so-called windfall profits tax, not only to remove the current unnecessary and costly administrative burden on taxpayers and the government, but also to remove the cloud on investments should there be future price increases.

Again, I appreciate being able to appear before you today and would be glad to answer any questions.

[The prepared written statement of Mr. Cummings follows:]

WRITTEN STATEMENT OF PROPOSED TESTIMONY BY

James R. Cummings

Deloitte Haskins & Sells

Mr. Chairman and Members of the Subcommittee:

My name is James Cummings and I am a partner of Deloitte Haskins & Sells, a large international accounting firm. I am currently the National Industry Director of our firm's Energy Resources Group and in that role, I supervise all of our firm's services to clients doing business in the oil and gas industry. I have held this position for a total of eight years. As a partner, I specialize in income taxes, with a large emphasis on income taxes affecting independent producers in the oil and gas industry.

This Subcommittee as well as others in Washington have a responsibility to keep our supplies of domestic petroleum reserves at a level whereby our dependence on imported products does not increase to a more dangerous level. I appreciate your efforts in this regard and hope that for America's well-being, you are successful.

The primary point that I intend to establish today is that, without changes to the existing alternative minimum tax (AMT) structure, both the existing oil and gas exploration tax provisions (i.e., IDC deductibility, percentage depletion allowances) and any increases in those allowances (e.g., increased percentage depletion deductions) will not accomplish the goal of stimulating domestic oil and gas exploration.

In addition to making my primary point today, I would like to voice my strong support for the repeal of the windfall profit tax and the enactment of an exploration tax credit, discussed by other witnesses today. I solidly support the use of Federal income tax provisions as a method to increase U.S. oil and gas reserves, thereby reducing this country's reliance on foreign sources of energy.

Although I cannot say with certainty, my experience in dealing with the tax matters of independent oil and gas producers leads me to strongly believe that, under existing tax law, most oil and gas independent producers who are actively exploring for and finding domestic oil and gas reserves will be subject to the alternative minimum tax. Many individual producers have found themselves in this position in the past, but now corporations and many more individuals will face this tax because of the provisions of the Tax Reform Act of 1986. This will result because the large deductions for IDC and percentage depletion resulting from an active, continuous and successful exploration program will consistently cause the taxpayer's regular tax liability to be less than the alternative minimum tax liability.

The primary business deductions for the oil and gas industry (depletion, IDC, depreciation of equipment) are all, to a certain extent, treated as preference items, which are not deductible for alternative minimum tax purposes. These items, coupled with the book/tax income preference and various percentage limitations, create traps for the unwary and serious disincentives for the wary.

I would like to emphasize that once the taxpayer is placed in the AMT position, additional deductions for IDC or percentage depletion usually gives the taxpayer no additional tax benefit and, in certain instances, may actually cause the taxpayer to pay additional taxes. A tax deduction from which a taxpayer receives no tax benefit cannot, in any sense, be viewed as a stimulant for domestic oil and gas exploration. In this statement, I have included some examples to emphasize the point I'm hoping to make. I believe the examples are necessary because the complexities of the alternative minimum tax computation often disguise the results with respect to specific deductions. The examples have been simplified to highlight those results.

PERCENTAGE DEPLETION DEDUCTIONS (Example 1)

Percentage depletion deductions in excess of tax basis have long been treated as tax preference items for both corporate and individual taxpayers. However, since corporations now are subject to an AMT (as opposed to an add-on minimum tax) and because of the increased preference treatment of certain IDC expenditures, more taxpayers than ever before will now be in an AMT position and thus, will receive no tax benefit with respect to tax preference depletion deductions. Consequently, the proposed changes to the existing limitations on percentage depletion deductions will have little effect in stimulating either increased exploration or retention of marginal wells unless corresponding relief from the AMT provisions also occurs.

In the attached example 1, we illustrate that an increase of percentage depletion deductions will not result in a reduction of a taxpayer's liability where that taxpayer is in an AMT position and the increase merely creates additional tax preference depletion.

INCREASED DEPLETION CAN CAUSE TAX INCREASE (Example 2)

In certain instances, it is possible for increased depletion deductions to actually result in an increased tax liability. Under existing law, the tax preference amount of IDC represents certain IDC expenditures reduced by 65% of net income from producing oil and gas properties. In determining the net income from oil and gas properties for the 65% test, percentage depletion deductions are deducted from the net income amount. Consequently, in certain situations where percentage depletion amounts are increased, the increased depletion deduction results in an additional amount of IDC being treated as tax preference IDC and, thus, the ultimate AMT liability actually increases. See example 2 (attached), in which a $850,000 increase in depletion deductions resulted in a $110,000 increase in alternative minimum taxes. This $110,000 can be computed as 20% of 65% of the additional $850,000 of depletion. The net result is a tax paid on a deduction taken. This clearly is inequitable.

IDC CAPITALIZATION OPTION (Example 3)

When a taxpayer finds himself in an AMT situation, there exists an option to capitalize certain IDC expenditures and deduct those expenditures ratably over a period of ten years, as nonpreference items. It is important to note that when a taxpayer is subject to the 65% limitation placed on percentage depletion deductions (as many oil and gas producers are), the effect of the IDC election discussed above is to cause the 65% limit to be increased, thereby permitting an additional amount of percentage depletion deductions (current or carryforward) to be recorded. However, to the extent that the percentage depletion deductions represent preference items, the taxpayer will get no tax benefit from the additional depletion deductions. See the attached example 3 where an IDC election to capitalize $4,000,000 of IDC causes a taxpayer to deduct $1,040,000 of additional percentage depletion deductions for which no tax benefit is received. Notice that the taxpayer's percentage depletion carryover declines from $1,500,000 to $460,000 because of this election. The taxpayer pays $180,000 more tax. This $180,000 in tax results from the increase in AMT of $900,000 as a result of the deferred IDC deductions, but the taxpayer receives no benefit from the loss of the depletion carryover. This is an example of an election that is supposed to be beneficial but, for the unwary taxpayer, will actually result in a detrimental tax consequence.

IDC DEDUCTIONS (Example 4)

The Tax Reform Act of 1986 included tax law changes that will result in significantly more IDC expenditures being treated as tax preference items for purposes of the AMT. For the first time ever, IDC expenditures can now be treated as preference items for corporations. In addition, by reducing the net income offset from 100% of net income from oil and gas properties to 65%, the new law causes significantly more IDC expenditures by individual taxpayers to be considered preference items than under prior law. As shown in example 4 (attached), once a taxpayer is in an alternative minimum tax situation and once he has reached a point where his IDC expenditures are treated as preference items, no additional tax benefit is gained by making additional IDC expenditures. Therefore, the tax treatment of the expenditure no longer is viewed as an impetus to incur additional exploration expenditures. The stimulus becomes ineffective. In example 4, in situation 1, the taxpayer incurs $240,000 of alternative minimum tax while making $2,000,000 of IDC expenditures. In situation 2, the taxpayer doubles his total amount of IDC expenditures, yet still pays exactly the same amount of tax ($240,000) as in situation 1. Clearly, the cost of making the additional $2,000,000 of IDC expenditures has risen relative to the cost of IDC's which actually result in some tax benefit.

SUGGESTED CHANGES

I strongly support any tax provision changes which will result in additional depletion deductions becoming beneficially available for oil and gas producers. This includes, but is not limited to, repeal of the 65% and 50% limitations and the transfer rules now placed on percentage depletion deductions. However, it is important that any increases in percentage depletion deductions not be considered tax preference items as most oil and gas producers will not realize any benefit from the increase and, thus, the objectives motivating the percentage depletion increase will not be attained.

It is both inequitable and inconsistent with national interests that any situations arise where an oil and gas producer gets absolutely no tax benefit from a dollar spent on oil and gas exploration. It is my strong recommendation that IDC expenditures be removed from the list of items that are considered tax preferences. Alternatively, at a minimum, the IDC expenditures considered to be preference items should be only those in excess of 100% of net income from producing oil and gas properties (without inclusion of tax preference depletion) instead of the current 65% offset amount.

Although my primary point was to highlight problems with the alternative minimum tax, I would like to reemphasize my support for a credit for exploratory and certain other expenditures. Such a credit would, in my view, stimulate production to a much greater extent than other proposals. Again, to be effective, such credits should be creditable against the AMT.

Additionally, the windfall profit tax should be repealed. This tax, which is currently not raising any revenue, nevertheless creates a cloud of uncertainty over investment, because of uncertainty as to future profits should prices increase. In addition, complex, unnecessary and costly administrative burdens are imposed on both taxpayers and the government.

It is certainly recognized that solutions to our dependence on foreign oil will be difficult in that there will be a monetary cost. It will be hard to overcome the perception that tax reform is being reopened and certainly everyone is aware of the budgetary problems facing the country. However, I believe that it is imperative that a solution be found. In addition, it should be kept in mind that $78 billion has been collected under the windfall profit tax. This amount would surely have been diminished, if not eliminated, if earlier years were combined with later years when prices decreased.

Thank you for allowing me to appear before you today. I welcome any questions you might have.

EXAMPLE 1

(000'S)

	SITUATION 1	SITUATION 2
Oil revenue	$10,000	$10,000
Operating expense	(3,000)	(3,000)
Depreciation	(2,000)	(2,000)
IDC	(1,000)	(1,000)
Depletion	(1,500) (15%)	(2,000) (20%)
Regular taxable income	2,500	2,000
Preferences		
Depletion	1,500	2,000
Depreciation	350	350
IDC	- 0 -	- 0 -
Alternative taxable income	$ 4,350	$ 4,350
Regular tax liability (34% corp rate)	$ 850	$ 680
Alternative tax liability (20% corp rate)	$ 870	$ 870

EXAMPLE 2

(000'S)

	SITUATION 1	SITUATION 2
Oil revenue	$10,000	$10,000
Operating expense	(5,000)	(5,000)
Depreciation	(3,000)	(3,000)
IDC	(1,000)	(1,000)
Depletion	(650) (1)	(1,500) (2)
Regular tax liability	350	(500)
Preferences		
Depletion	650	1,500
Depreciation	500	500
IDC	122	675
Alternative minimum taxable income	$ 1,622	$ 2,175
Regular tax liability (34% corporate rate)	$ 119	$ - 0 -
Alternative minimum tax liability (20% corporate rate)	$ 325	$ 435

(1) 15% rate limited by the 65% limitation

(2) 15% rate 65% limitation repealed

EXAMPLE 3

	(000'S)	
	SITUATION 1	SITUATION 2
Oil revenue	$10,000	$10,000
Operating expense	(5,000)	(5,000)
Depreciation	(3,000)	(3,000)
IDC	(4,000)	(400) (2)
Depletion	- 0 - (1)	(1,040)
Regular tax liability	(2,000)	560
Preferences		
Depletion	- 0 -	1,040
Depreciation	500	500
IDC	2,700	- 0 -
Alternative minimum taxable income	$ 1,200	$ 2,100
Regular tax liability (34% corporate rate)	$ - 0 -	$ 190
Alternative minimum tax liability (20% corporate rate)	$ 240	$ 420
Percentage depletion carryover	$ 1,500	$ 460

(1) Limited to 65% of taxable income

(2) Elected to capitalize and ratably amortize all IDC

EXAMPLE 4

	(000'S)	
	SITUATION 1	SITUATION 2
Oil revenue	$10,000	$10,000
Operating expense	(5,000)	(5,000)
Depreciation	(3,000)	(3,000)
IDC	(2,000)	(4,000)
Depletion (Ltd 65% rule)	- 0 -	- 0 -
Regular taxable income	(- 0 -)	(2,000)
Preferences		
Depletion	- 0 -	- 0 -
Depreciation	500	500
IDC (net of 65% offset)	700	2,700
Alternative minimum taxable income	$ 1,200	$ 1,200
Regular tax liability	$ - 0 -	$ - 0 -
Alternative minimum tax liability (20% corporate rate)	$ 240	$ 240

Senator BOREN. Thank you very much, Mr. Cummings. And we will receive your full statement, including the examples you cited of the impact of the alternative minimum tax for the record, and I think it will be very helpful and illuminating to those who will be studying the record.

Let me ask Dr. Fisher, what do you predict will happen to the U.S. production in our Prudhoe Reserve base if we make absolutely no changes in terms of tax law and other laws during the One Hundredth Congress?

Dr. FISHER. Well our projections which I gave in a report to Senator Bentsen last March was that lower 48 production would go to about an average of 4.7 million barrels a day for the 1990 to 1995 period. It is falling down through that time. That, incidentally, is the same average level that DOE projects for the lower 48. And then we are going to additionally lose upward of about a half a million barrels by 1990 from Alaska, and that will continue on down if we do not put any additional production on.

So we are looking at production levels by 1995 on the order to 60 percent of what they were in 1985. So that is a 40 percent loss in less than a decade.

Senator BOREN. And looking at those domestic production projections and considering what you project demand to be, what would the result be in terms of our dependence upon foreign sources for our oil?

Dr. FISHER. If you make the assumption that the increase in demand is going to be 1 percent a year with these projections in loss of production capacity, you will be at the 50 percent level sometime in 1989 or essentially in 1990. So within a couple of years on those assumptions.

I think the real joker in point at which you reach that, and the argument here is whether you are going to reach it within three years or four, is the assumption you make relative to consumption itself.

Senator BOREN. Yes.

Dr. FISHER. If it beats 1 percent you will get there quicker. If it is a little bit less than 1 percent you might get yourself another year. But that is the only real variable in it that has any debate at all.

Senator BOREN. Mr. Hefner, we have gone from a $10.00 or so prevailing price in 1986 and we are back up to the 16, 17 now, approaching $18.00, in the $18.00 range. Why has there not been more of a response in terms of increased exploration, more drilling rigs in operation than we have seen? The levels remain have been very slight movement, but the level remain certainly low. There doesn't seem to be a very wide response at this point.

Mr. HEFNER. I agree with you, Senator Boren, that there has been very little response, if any. It would be my opinion that we have not had enough of an increase in the price yet to offset the disincentives that were created by the 1986 Tax Reform Act.

Senator BOREN. So the minimum tax is a part of this?

Mr. HEFNER. Yes, sir. It is a very distinct part of it.

Senator BOREN. Is instability, uncertainty about where prices are going also another factor?

Mr. HEFNER. Instability is one of the things that we have worried about forever in this industry. We have never had what a banker would call stable industry as a result of not knowing what our price would be tomorrow for our product, or what it will be in the short-term future, let alone the mid-term or long-term future.

Yes, sir, instability is one of the problems that we face.

Senator BOREN. Let me ask all four of you maybe just to comment briefly on this question. Tax credits have been discussion, in addition to windfall repeal and work on the minimum tax, and the other technical changes—transfer rule and others—that have been talked about, but tax credits have also been talked about. But would it be better to provide a relatively large tax credit on a narrow base, let us say, wildcat drilling as opposed to just developmental drilling, and the marginals, or would it be better to provide a smaller credit on a broader base, in your opinion? I would just ask each one of you, if you wish—you don't have to, but each one of you might want to comment on that. Dr. Fisher?

Dr. FISHER. I would think it preferable to have a smaller rate on a broader base. You have got a lot more flexibility in application in that way. You have to presume a certain knowledge is precisely what part of the resource base is the best one to credit if you make it high and narrow?

So 5 percent across the board is what I would recommend in any case.

Senator BOREN. Mr. Hefner.

Mr. HEFNER. I would agree with Dr. Fisher on the broader base smaller percentage tax credit. I am not sure that I would agree on the 5 percent. I would like to see a much higher number, of course. [Laughter.]

Wildcat exploration drilling is extremely important; so is development drilling to the nation's security. And I think that I would certainly agree that tax credits should be on a broader base.

Senator BOREN. Mr. Gibbens.

Mr. GIBBENS. I think that is correct, Mr. Chairman. Eighty percent of the wells drilled in the United States are classified as development or extension wells and they find 90 percent of the reserves. So the broader tax credit is more beneficial.

Senator BOREN. Mr. Cummings.

Mr. CUMMINGS. I would agree with that also. I do think, however, that you could at least consider perhaps a different rate, for instance, for wildcat wells.

Senator BOREN. Some differential.

Mr. CUMMINGS. Right.

Senator BOREN. Maybe some additional incentives, but not so great as to prevent you from doing a broader credit as well.

Mr. CUMMINGS. Correct.

Senator BOREN. Thank you very much. Senator Bentsen?

The CHAIRMAN. Thank you very much, Mr. Chairman.

I am sorry I could not have heard all the comments or testimony but I had some conflicting commitments this morning.

You know, it is awfully easy to design incentives that are going to help this industry. The problem is to design an incentive that is politically possible that you can pass. I certainly understand the concern about the alternative minimum tax. That is a pretty tough hill to climb in the Congress after the Tax Reform bill.

Whatever tax incentives were, I think you still have to consider the impact of the alternative minimum tax.

As I look over the testimony—and I was looking over yours, Mr. Hefner—one of the ideas suggested appeals to me. You know, I support an oil import fee. However, it seems to me that adding stability to the market by enacting a floor price takes care of a lot of the political arguments against an oil import fee. It certainly would settle some of the butterflies in some of the bankers' stomachs, and, in turn, would encourage them to make loans for further drilling.

And you estimate some 300 million barrels a day you would add to the reserves?

Mr. HEFNER. That was Dr. Fisher's remark.

The CHAIRMAN. Was that yours, Dr. Fisher?

Dr. FISHER. Yes, sir, 300 million barrels a year.

The CHAIRMAN. That is a highly significant amount.

Dr. FISHER. Yes.

The CHAIRMAN. And your testimony looks at 1990. By 1990, production will be about 1.2 million barrels more than if the market continues to discount the price of oil prices to $15.00 per barrel. That may be one of the more saleable approaches for us in trying to help this industry. A floor might stabilize this industry and encourage drilling of new wells, whether it be development, wells that you were referring to, Mr. Gibbens, or whether we are talking about exploratory wells.

Dr. Fisher, we were talking earlier about what happened with these assumptions regarding U.S. dependence on foreign oil. I look at the Department of Energy's numbers, and then I look at your numbers, and I see some similarity there and yet I see some difference in the end result. Obviously there was some difference in economic assumptions used. Can you tell me or explain to me why the DOE came up with different conclusions?

Dr. FISHER. Well I don't know that the conclusions differ on the margin in the production forecast that they have made. And again, I am assuming the lower price range which is comparable of what we are looking at, and based on the assumption that you are going to be in the 15 to 16 dollar range.

The projections that DOE made and the ones that I made for you are almost precisely the same for lower 48 crude production. They are a little bit higher in 1990 than I was and they are a little bit lower in 1995 than what I projected. But the average for that remains about the same.

You get into the issue on Alaska production up yonder. It is a question, we know Prudhoe Bay is scheduled to go in decline either late in 1988 or sometime in early 1989. And that is a 12 percent loss. And we agree in our projections there. It is a question of how much might come on to back that out on the North Slope. But at $15.00, my assumption is not very much.

The areas where I think the DOE projection probably made the issue look a little bit firmer than it might have done so is that the entire refinery gain that comes from the refining process of crude oil, which amounts to about 600,000 barrels a day, was credited to U.S. supply, and that is off of imports too, so that is repeating it. And natural gas liquid production was held steady through the time frame. It actually increased a little bit through the time frame of the balance of this decade and into 1995.

And if I look at the underlying deliverability situation on natural gas, natural gas is declining. The only thing that is maintaining a surplus now in natural gas is because demand is eroding about as fast as the deliverability capability is declining. So we are losing a lot of capability there. And I think I would differ with them in holding natural gas liquids up to their level. But if you take refinery gain, and keep those high, and credit them entirely, and then use natural gas liquids, then you can soften a little bit of this real sharp decline that we are seeing in crude oil. I don't think you should do that, but that was the principal difference between the projections I made for you and the ones that were in Bill Martin's report.

The **CHAIRMAN**. I am very pleased to have witnesses of the caliber that we have here. We can come up with all kinds of incentives on our own. But there is no sense going through that, and fighting those fights, and picking up those scars unless you have accomplished something that makes it worth the effort. And, Mr. Cummings, that is why it is important to have your technical expertise here. And, Mr. Hefner, I have talked to producer after producer, and they tell me the same thing you are telling me. Unless we do something to change the alternative minimum tax, these producers don't think we will have much of an impact on oil and gas reserves.

What has happened is they have called a vote. That is where Senator Boren has gone, and that is where I am going to have to go in a minute. And that just happened.

You have the one light on the left and it tells you that you have a vote. Then you get five up and you are half way through. The amber one on the right says you are in session. When you get two of them it is a temporary recess. When you get three of them you have got a live quorum. At four, it is at the end of the day's business. Six of them, it is the end of the morning business. And what I am trying to get across to you is how important seniority is to understand that. [Laughter.]

The **CHAIRMAN**. Now with that in mind, I am going to go vote. We will put this hearing in recess. Senator Boren will be back in just a minute.

[Whereupon, at 12:12 p.m., the hearing was recessed.]

AFTER RECESS

Senator **BOREN**. All right. We will resume. I apologize. We never know when these votes are going to intervene. And I apologize to those on the last panel that I had to leave before all the questioning period was completed, but I will read the questions and answers with interest.

Our next panel is composed of Mr. James Stafford, Executive Director of the National Association of Royalty Owners; Mr. Charles DiBona, President of the American Petroleum Institute; Mr. Richard Robitaillie, Executive Director of the Petroleum Association of Wyoming, Casper, Wyoming; and Dr. Mark Cooper, Director of Research, Consumer Federation of America. We are very glad to have all of you with. Again, I apologize that we were delayed temporarily. We will try to again move right along. I don't know if any of our colleagues will be able to come back and join us or not, in light of the other things that are going on right now over on the floor.

Let me ask Dr. Cooper if you would proceed at this time the Director of Research at Consumer Federation of America. We are very glad to have you with us and to hear your point of view in these hearings.

STATEMENT OF DR. MARK COOPER, DIRECTOR OF RESEARCH, CONSUMER FEDERATION OF AMERICA, WASHINGTON, DC

Dr. COOPER. It is a somewhat different point of view than you have heard.

We believe it would be a grave error for this nation to pursue an energy policy that seeks to achieve a sense of security based on the mistaken notion that we can somehow produce our way out of dependence on the world's oil market. As a high cost supplier with diminishing resources, dependence on imports is inevitable.

National energy policy should be composed of domestic policies which minimize the impact of any future oil supply and price shock and international policies that reduce the likelihood of such shock. If Congress finds it necessary to spend consumer dollars in the name of reducing imports or enhancing national energy security, we believe that those dollars would be best and should be first spent in stockpiling oil to meet the threat of sudden shock and in lowering consumption through conservation to reduce long-term vulnerability.

If oil will be imported at prices that are below the cost of production or subsidized in some other way, then there would be a firm basis for government action to protect the domestic industry from unfair foreign competition. But that is not the case with oil. The current price of oil remains well above the economic cost of production at the margin in a number of locations throughout the world, both within and outside of OPEC.

The fact that domestic U.S. resources are higher in cost than elsewhere in the world cannot be blamed on tax policy. On a per barrel basis, taxes collected in this country are lower than in most other countries. We are simply a high cost supplier.

The underlying economics of the world oil industry indicate the potential for long-run price stability. However, the experience of the 1970s demonstrated that the world's oil market is highly volatile. Physical shortages were very small and short lived in 1973, and probably never actually occurred in 1979. The cost for production were not the cause of instability; rather, political actions on the supply and overreactions on the demand side created wild jumps in price.

Recognizing that the source of instability in the world's oil market is not the economic cost for production, pursuit of energy security must entail responses that address the underlying political and demand side problems.

Creating artificial incentives which will accelerate the development of domestic resources that cannot be produced at current prices is not the way to do so.

Since 1974, over half of the exploration activity and 80 percent of the drilling activity in the world have taken place in the United States, even though more than 80 percent of the likely reserves are located elsewhere. Yet, even with this tremendous amount of drilling, this intensive drilling, we have not been able to keep the reserve of production ratio up in this country.

Direct efforts to accelerate the domestic production in the past were equally disappointing from the point of view of national energy security. The oil import quotas imposed in the late 1950s were based on the premise—exactly the same premise we hear today—that increasing imports constituted a threat to national security. Yet the import quota accelerated the draw down of domestic reserves, frequently referred to as "Drain America" first, dissuaded the U.S. from pursuing more appropriate policies and rendered us more vulnerable to the price shock of the 1970s.

As domestic resources were being depleted, even though their costs were far above the worldwide costs, the import quota drained America first. Low cost oil was stockpiled in the Middle East and more expensive oil was depleted here. We believe that production stimulation polices in the 1980s will repeat the errors of the 1960s. In the long term, a diversity of low cost oil supplies available in the international market is the key to encouraging security, and it is vastly preferable to the overdevelopment of domestic resources.

Building reserve with this short-term reductions in supply is especially critical since it lowers the cost of any potential emergy supply interruption that will be imposed on importers. Its storage research capacity as well as energency measures can fully meet demand in the event of a large supply disruption. They serve the function of reducing the cost of those disruptions and lowering their probability.

Ultimately from our side, efforts to encourage long-term conservation, reduce the potential economic cost of disruption and the political leverage involved in manipulating supply.

In conclusion, we believe that short-term energy vulnerability can be reduced only through sufficient stockpiling to insure that oil is available during disruptions. Long-term energy vulnerability can be reduced through diversification of international supplies and reduction of domestic consumption.

Seeking to stimulate domestic production either by reducing tax liabilities with the royalty companies or raising consumer prices is bad energy policy because it squanders scarce resources on an ineffective approach to the problem of national energy security.

Thank you.

Senator BOREN. Thank you, Dr. Cooper.

We will now hear from Mr. DiBona, representing API.

[The prepared written statement of Dr. Cooper follows:]

TESTIMONY
OF
DR. MARK N. COOPER
DIRECTOR OF RESEARCH
CONSUMER FEDERATION OF AMERICA

Mr. Chairman and Members of the Committee,

Founded in 1968, the Consumer Federation of America (CFA) is the nation's largest consumer advocacy group. Composed of over 200 state and local affiliates representing consumer, senior citizen, low-income, labor, farm, public power and cooperative organizations, the Consumer Federation of America's purpose is to represent consumer interests before Congress and the federal agencies.

We greatly appreciate the opportunity to testify before the Committee today. CFA has an ongoing interest and involvement in national energy policy formation and in oil and gas policy in particular. In the past three years we have conducted three major analyses of oil policy, which I submit for the record.

Our analysis leads us to conclude that it would be a grave error for this nation to pursue an energy policy that seeks to achieve a sense of security based on the mistaken notion that we can somehow produce our way out of dependence on the world oil market. Such efforts will inevitably fail and render the U.S. even weaker and more vulnerable to future supply shocks.

As a high cost supplier with diminishing resources, dependence on imports is inevitable. Because the oil resource base within our borders is diminishing, the United States can no longer be the guarantor of oil supplies in the international market as we were a decade and a half ago. National energy policy should be composed of domestic policies which minimize the impact of any future oil supply and price shocks and international policies which reduce the likelihood of such shocks.

If Congress finds it necessary to spend consumer dollars in the name of reducing imports or enhancing national energy security, we believe that those dollars would be best spent in stockpiling oil to meet the threat of sudden shocks and in lowering consumption through conservation to reduce long term vulnerability.

The starting point in arriving at this conclusion is the underlying economics of resource production. If oil is being imported at prices that are below the cost of production or subsidized in some other way, or if an extremely large price difference is based on inordinate wage differentials, then there would be a firm basis for government action to protect the domestic industry from unfair foreign competition. However, that is not the case with oil.

The current price of oil, hovering around $19 per barrel, represents a market clearing price of oil in a situation in which political and administrative decisions to withhold supply have been dramatically reduced compared to recent years. The current price of oil remains well above the economic costs of producing oil at the margin in a number of locations both within and outside of OPEC.

If there were absolutely no restraints on production within the OPEC nations, the oil market would probably clear at a considerably lower price, given reasonable assumptions about user costs and rates of return. Thus, the price is certainly not predatorily low. Moreover, based on current levels of production within OPEC and the costs of production outside of OPEC, the world oil market could sustain the current price level for the mid-term and would exhibit only moderately rising real prices for the mid to long term.

The fact that domestic U.S. resources are higher in cost than costs elsewhere in the world cannot be blamed on tax policy. On a per barrel basis royalties and taxes collected in this country are lower than in most other countries in the world. We are simply a high cost supplier.

The underlying economics of the world industry indicates a potential for long run price stability. However, the experience during the 1970s demonstrated that the world oil market is highly volatile. Physical shortages were very small and short lived in 1973 and never actually occurred in 1979. The cost of production was not the cause of instability. Rather, political actions on the supply-side and over reaction on the demand-side (aggressive hoarding and price bidding) created wild swings in price.

Recognizing that the source of instability in the world oil market is not the economic cost of production, pursuit of energy security must entail responses that address the underlying political and demand-side problems. Creating an artificial incentives which will accelerate the development of domestic resources that cannot be produced at current prices does not do so. Such a policy implies that we are better off moving domestic production into the present, rather than waiting for the depletion of lower cost reserve elsewhere to move the world price to a level that renders U.S. resources economic.

Because the world resource base has been significantly underexploited, the gap between the costs of production in the U.S. and the rest of the world is large and likely to persist for the long term. Since 1974, for example, over half the exploration activity and 80 percent of the drilling activity have taken place in the United States even though more than 80 percent of the likely reserves are located elsewhere. Yet, because the resource base has been depleted in this country, even this intensive exploration and development has not been able to keep up reserves in this country. The depletion of the domestic resource base is reflected in a steady decline in the reserve-to-production (R/P) ratio in this country, in contrast to a steady R/P ratio abroad.

The R/P ratio in the U.S. declined from almost thirty years in 1947 to just over 11 years in 1973. The decline since 1973 has been slower, but it continues. The decline in the reserve to production ratio in the U.S. since 1980 has come in spite of a decline in annual consumption of more than 10 percent and in spite of the fact that more wells were drilled in this country between 1980 and 1984 than had been drilled in the entire the previous decade.

In contrast to declining reserves in the U.S., the reserve to production ratio in the world increased from 22 years in 1947 to 40 years in 1960, then declined to 32 years in 1973. Since then it has risen to approximately 36 years.

Thus, even the drilling boom of the 1970s could not reverse the decline in U.S. reserves or close the gap with the rest of the world. Direct efforts to accelerate domestic production in the past were equally disappointing from the point of view of national energy security and policy.

The oil import quotas imposed in the late 1950s, which remained in effect until the early 1970s, were based on the premise that increasing imports constituted a threat to national security. Yet, the import quota accelerated the drawdown of domestic reserves, dissuaded the U.S. from pursuing more appropriate policies, and rendered us more vulnerable to the price shocks of the 1970s.

In 1957, the year before the imposition of the quota, domestic supplies were about 11 percent more expensive than foreign supplies. By 1972 this gap had grown to almost 30 percent. At the margin, costs were probably close to twice the world price.

As domestic sources were being exploited, even though their costs were far above the world price, the import quota was forcing the accelerated drawdown of domestic reserves. It is impossible to know exactly how much larger U.S. reserves would have been in 1973, absent the import quota, however, it is certain that utilization of U.S. reserves and the much vaunted peak of production in the U.S. would have been shifted well into the future. Although estimates vary, at the end of the quota period, the quantity of potential imports that had been excluded and domestic reserves that had been depleted on an accelerated basis certainly equaled one-third of the total proved reserves remaining in the country.

At a minimum, it must be recognized that a 15 year period of exhausting domestic supplies whose economic costs were considerably higher than available supplies elsewhere created a major distortion in the world resources base. Low-cost oil had been stockpiled in the Middle East and more expensive oil had been depleted here. Production stimulation policies in the 1980s will certainly repeat the errors of the 1960s.

Recognizing that domestic oil development choices are simply choices about the timing of production from a declining base and that the underlying "problem" in the world oil market is political, not economic, the key to reduce energy vulnerability lies in diminishing the potential for instability in the international market and reducing the impact of instability on the domestic economy.

In light of the declining domestic resource base, in the long term, a diversity of low-cost oil supplies available in the international market is preferable to encouraging the overdevelopment of the domestic resource base. Over the past decade, considerable progress have been made toward diversification.

Mexico, Canada, and the United Kingdom are major sources of export oil and U.S. imports as are a host of other countries -- Norway, Australia, the Netherlands, and Trinidad. Not only are the imports of OPEC oil into the United States down, but production from non-OPEC sources is up.

Building a reserve to resist short term reductions in supplies is especially critical, since it lowers the costs that any potential energy supply interruption will impose on importers and the benefits that will flow to exporters. If storage or surge capacity, as well as emergency conservation measures, can fully meet demand in the event of a large supply disruption, they serve the function of reducing the costs of disruptions and lowering their probability. Analysis from a strategic commodities point of view places a great deal of emphasis on stockpiling.

Efforts to encourage long term conservation reduce the potential economic costs of disruption and the political leverage in manipulating supplies.

To underscore the fact that oil can be viewed in the same context as a number of other strategic materials and that conservation is the key component of long term security, Table 1 compares several key characteristics of the production, trade and consumption of oil to the characteristics of seven other strategic materials.

With respect to sources of supply, oil is much less of a strategic problem. Our import dependence for oil is less than for the other materials and the concentration of our imports is less -- that is we import a smaller percentage of the oil we consume from a wider range of suppliers. For most of the strategic commodities, the distribution of known reserve is much more concentrated than for oil, although the magnitude of reserves is larger for these other strategic commodities.

On the other hand, viewed as an industrial input, oil has a greater importance than the other commodities. It is more pervasive throughout the economy. We also consume very large physical quantities of oil. Oil products do possess the unique characteristic (in contrast to other strategic materials) of being consumed directly by the public in large quantities. These characteristics give oil a special ability to alter the level of economic activity.

However, in some respects there is greater substitutability for oil. In many uses -- particularly as boiler and heating fuel -- substitutes for oil are much more readily available than are substitutes for the other strategic materials. The United States has also exhibited a significant capacity to curtail oil consumption while achieving economic growth (see Figure 1). Since 1973 overall energy consumption per unit of economic output has declined by 25 percent. Oil consumption per unit of economic output is down 30 percent. In comparison to other industrial nations, the potential for further conservation at home remains considerable.

With over 60 percent of all oil products consumed in the transportation sector, the ability to conserve on or substitute for oil in automobiles and trucks is particularly important. Indeed, in

TABLE 1:

CHARACTERISTICS OF STRATEGIC COMMONDITIES

COMMODITY	ECONOMIC CHARACTERISTICS (a)			IMPORT PATTERNS		RESOURCE PROSPECTS			
	NUMBER OF FIRST ORDER INDUSTRIES	PERCENT OF TOTAL DEMAND	PERCENT OF GNP	PERCENT OF TOTAL CONS (b)	4 NATION CONCENT RATIO (c)	R/P RATIO IN YEARS (d)	PROJECTED ANNUAL GROWTH RATE (e)	4 NATION RESERVE CONCENT. RATIO (f)	U.S. RESERVES AS % OF WORLD (g)
OIL	12	85	58	33	49	36	1.5	50	3
ALUMINUM	20	83	8	96	85	285	6.3	66	0
CHROMIUM	32	75	16	82	98	815	6.5	98	0
COBALT	10	78	3	95	67	275	3.1	67	10
MANGANESE	2	75	12	99	96	480	5.1	96	0
PLATINUM	5	85	3	91	100	179	2.5	100	1
TITANIUM	4	100	1	9	N/A	255	N/A	N/A	N/A
TANTILIUM	N/A	N/A	N/A	94	62	92	3.1	71	0

(a) Bullis and Mielke, STRATEGIC AND CRITICAL MATERIALS (Westview Press, 1985) for non-oil; U.S. Department of THE DETAILED INPUT-OUTPUT STRUCTURE OF THE U.S. ECONOMY, 1977 (Washington, 1984), for oil.

(b) Nonoil, ibid., p.40.; oil, U.S. Department of Energy, MONTHLY ENERGY REVIEW (MER), July 1986, pp. 36-37.

(c) Non-oil, Bullis and MIelke, p. 134; MER, pp. 42-43.

(d) Non-oil, Bullis and Mielke, pp. 55-66; American Petroleum Institute (API), BASIC PETROLEUM DATA BOOK, September, 1985, Table 3c.

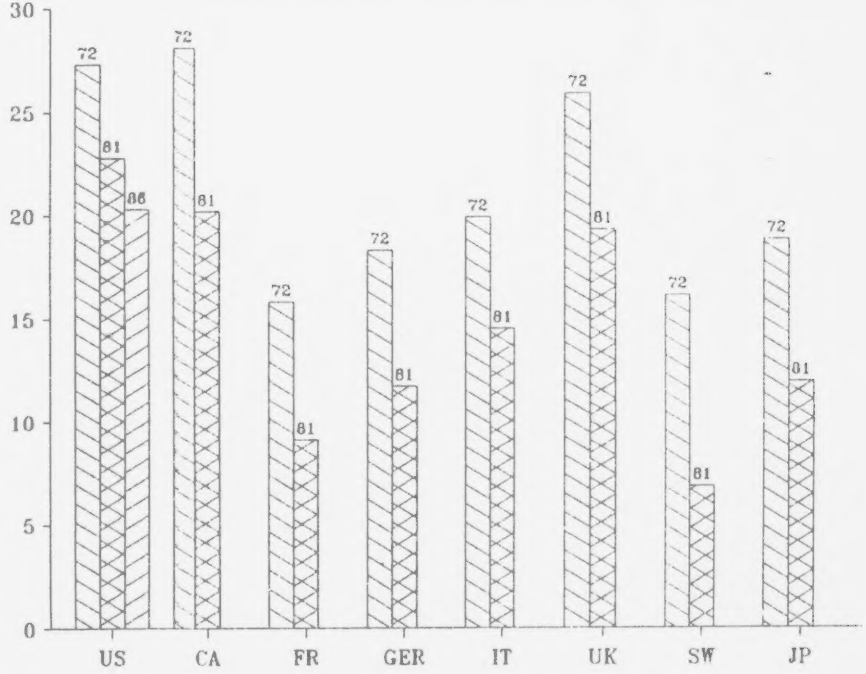
(e) Non-oil, Bullis and Mielke, p. 57; oil Energy Information Administration, THE IMPACT OF LOWER WORLD OIL PRICES AND ALTERNATIVE ENERGY TAX PROPOSALS ON THE U.S. ECONOMY, April 18, 1986, p. 7.

(f) Non-oil, Bullis and Mielke, pp. 172-173; API, Table 3c.

(g) Bullis and Mielke, p. 50; API, Table 3.

FIGURE 1:

OUTPUT PER UNIT OF ENERGY CONSUMED



SOURCES: U.S figures are from MER, p. 12. Comparative figures are from J. Darmstadter, J. Dunkerly and J. Alterman, *How Industrial Societies Use Energy* (Resources for the Future, 1977), p. 22 and J. Gever, R. Kaufmann, D. Skole and C. Vorosmarty, *Beyond Oil* (Ballinger, 1986), pp. 83-84.

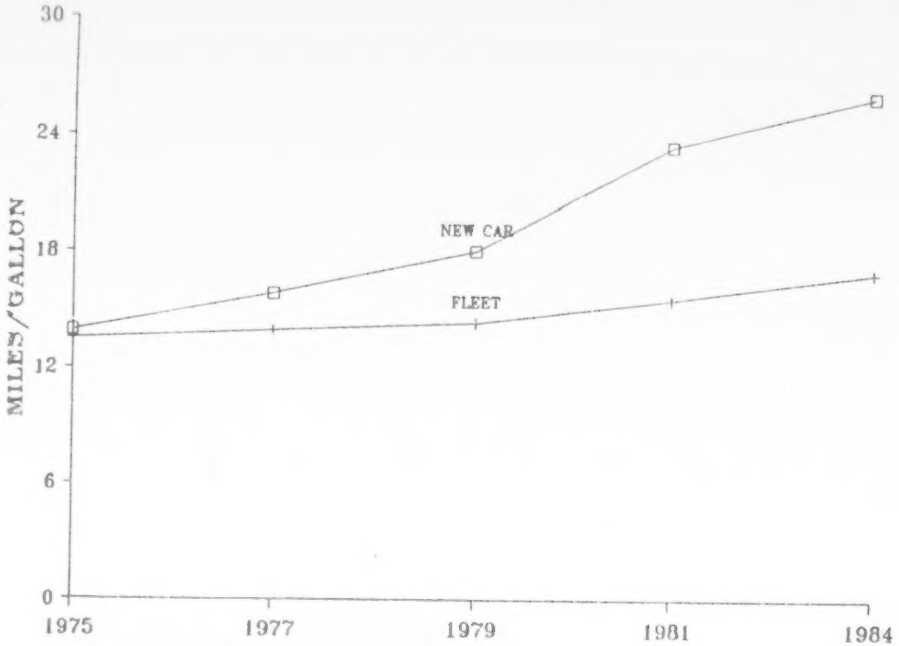
many respects the energy problem is strictly a transportation fuels problem. Here the achievement and prospects for conservation are encouraging. Although the ability to find alternative fuels for transportation purposes is limited, compared to other end-uses, the potential for conservation is very large. Average fleet fuel efficiency has increased by 30 percent since 1973. With new car energy efficiency almost twice that of the existing stock of cars, the potential future savings is also large (see Figure 2).

Thus, because of the greater substitutability for oil and the potential for conservation, projected levels of increase in demand for oil are generally lower than for other strategic commodities.

In conclusion, we believe that short term energy vulnerability can be reduced only through sufficient stockpiling to ensure that oil is available during disruptions. Long term energy vulnerability can be reduced through diversification of international supplies and reduction of domestic consumption. Seeking to stimulate domestic production either by reducing tax liabilities of oil companies or raising consumer prices is simply bad energy policy because it squanders scarce resources on an ineffective approach to the problem of national energy security.

FIGURE 2:

AUTOMOTIVE FUEL ECONOMY TRENDS



SOURCES: MER, p. 15. D. L. Greene, "Highway Fuel Use: Trends and Factors," in the Energy Information Administration, Proceedings of the Energy Information Administration Symposium on Petroleum Supply Information (September, 1983).p. 184. The 1985 on road new car fuel consumption assumes the difference between the manufacture test standard and actual achieved efficiency (1.5 MPG) that obtained in 1983 also obtains in 1984.

STATEMENT OF CHARLES DiBONA, PRESIDENT, AMERICAN PETROLEUM INSTITUTE, WASHINGTON, DC

Mr. DiBona. Thank you, Mr. Chairman.

I would like to thank you for this opportunity to testify on a subject that is of the utmost importance to the country.

It is widely agreed that a high degree of dependence on imported oil could pose serious problems to the U.S. economy and national security in the 1990s when the world oil market is likely to be much tighter than it has been in recent years. And that is the key to why we are so worried about the increased dependence combination of those two things that I think Dr. Cooper has ignored.

The most direct way to reduce the degree of import dependence is to encourage a healthy domestic petroleum industry; not the only thing we could be doing but a very important part.

Today, the American petroleum industry is in a depressed state. My remarks this morning will focus on some of the positive actions the Congress could take, more investment in new oil drillings.

The first suggested action is to repeal the windfall profits tax. There are several important reasons for repealing the tax now. It is a disincentive to future domestic production; it imposes heavy administrative costs on taxpayers and government, and even though it generates little, if any, revenue, it is uniquely applied to a single industry, and so is inconsistent with fundamental tax fairness. There are no windfall profits from decontrol to be taxed.

Because the windfall profits tax imposes an economic disincentive on future production, it makes many domestic oil exploration projects unattractive, and because it will extract a large penalty on production from existing fields when oil prices rise, it serves to decrease the available pool of internally generated cash which provides a major source of exploration and production capital.

Even under current price conditions when the tax rises, it raises little, if any, revenue; it continues to impose a heavy cost.

Mr. Gibbons mentioned our study which estimated the cost on producers at $100 million annually. That does not count audit costs. And I might interject at this point to note that the gentleman from the Department of Energy who estimated a 15 to 25,000 barrel per day effect per dollar as a consequence of existence of tax, I think that is off by an order of magnitude. I think it is more like 150,000 barrels a day. Our estimates of the effect of price changes on oil production are more consistent with numbers on that order, and our estimate of the effect of the tax over the last several years on oil production through, say, 1985 was a reduction in production of about a million barrels per day.

Senator Boren. I think it might be well, and we would leave the record open to receive this, if you would place in the record past studies which have been done which tie changes in price with production response, because that would show, when you are talking about taking 70 percent of the price change away through an excise tax, that would give us an accurate figure as to production response. But I was also puzzled by that figure. And we would be willing to receive that for the record if there are additional studies of that.

Mr. DiBona. Yes, sir.

[The studies follow:]

RESPONSE TO QUESTIONS POSED
TO CHARLES J. DiBONA
BY SENATOR DAVID BOREN

What is the relationship between price and crude oil supply?

A large number of econometric studies of the supply of crude oil gross reserve additions in the U.S. have yielded estimates that the price elasticity of such supply is in the range from 0.7 to 1.6, implying that a 10% price decline, or an equivalent 10% excise tax, could be expected to generate between a 7% and a 16% change in the rate of gross reserve additions. These estimates, while derived largely from studies conducted prior to 1974, are consistent with the behavior of gross reserve additions in the U.S. since that time. As seen in Exhibit 1, the increase in the rate of gross reserve additions has slightly exceeded the rate of price increase in the post-1973 period, suggesting an elasticity of slightly greater than 1, well within the range suggested by past studies.

The effect of the Windfall Profits Tax was to keep the effective price faced by domestic producers in the period from 1980 to 1985 well below the world price, by imposing an excise tax on domestic production which varied by category of oil. On average, this liability amounted to $4.18 per barrel during the 1980-85 period, implying that the price received by domestic producers would have been about 17% higher during the 1980-85 period without the tax. Using the price elasticity suggested by the data in Exhibit 1, this would imply that gross reserve additions during the period would have been about a half million barrels higher each year in the absence of the tax, so that the cumulative loss of reserves due to the tax would have reached nearly 3 billion barrels by the end of 1985. At current production to reserve ratios in the U.S., this would imply a loss of nearly 800 thousand barrels daily of U.S. production capacity by 1985, as shown in Exhibit 2.

Admittedly, given the complexity of the tax structure, this estimate is subject to a great deal of uncertainty. As shown in Exhibit 3 the rate of the excise tax varied significantly across categories and years, ranging from as high as $12.77 per barrel on Tier 1 production in 1981 to virtually negligible amounts on Tier 3 by late 1985.

To the extent that the tax on new reserve additions had been limited to Tier 3 rates, the true impact of the tax would have been less than half that estimated above. However, the pattern of reserve additions actually realized since 1980 indicates quite the opposite. As shown in Exhibit 4 the overwhelming majority of reserves added since 1980 were the result of development activity at old fields, rather than new discoveries, suggesting strongly that the preponderance of reserve additions may actually have fallen into the highest tax categories, easily doubling the impact over what was estimated above.

Exhibit 1. Response of Domestic Crude Oil Gross Reserve Additions to Price in the Post-1973 Period

	1974-1979	1980-1985	Percentage Change
Price(1982 $/bbl)	$14.75	$24.84	68.4%
Annual Gross Reserve Additions (billion bbls)	1.589	2.765	74.0%

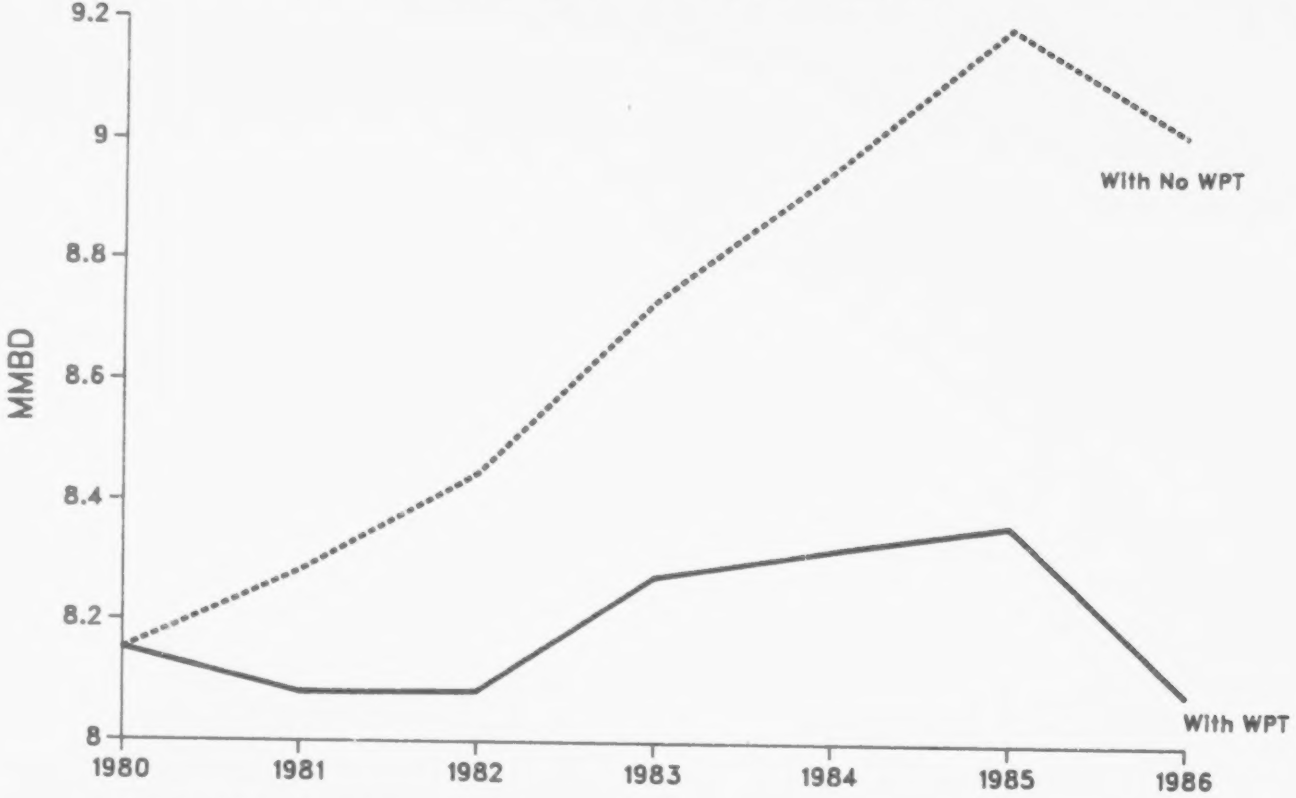
Source:
Price is the average per barrel sales value of domestic crude oil, net of WPT, deflated by the U.S. GNP deflator. Average gross reserve additions are the average annual rate of gross crude oil reserve additions. Price and production data from U.S. Department of Energy, Monthly Energy Review. Reserve addition data from U.S. Department of Energy, U.S. Crude Oil and Natural Gas Reserves. WPT data from U.S. Department of Treasury, Statistics of Income Bulletin. GDP deflator from U.S. Department of Commerce, Survey of Current Business.

Exhibit 3. Windfall Profit Tax Liability ($ per barrel)

	1981	1983	1985
Tier 1			
Sadlerochit	$5.13	$0.48	$0.19
Non-Sadlerochit			
70% Oil	$12.77	$7.34	$5.49
50% Oil	$9.27	$5.85	$3.84
Tier 2			
60% Oil	$9.42	$4.49	$2.61
30% Oil	$4.87	$2.70	$2.03
Tier 3			
Newly Discovered	$4.18	$1.19	$0.06
Tertiary	$3.69	$1.48	$0.14
Heavy Oil	$2.59	$0.39	$0.05

Source:
U.S. Department of Treasury, Statistics of Income Bulletin, various issues.

Exhibit 2
U.S. Crude Oil Production



MMBD = Million barrels per day
WPT = Windfall profits tax

Exhibit 4. Sources of U.S. Gross Reserve Additions, 1980-84

	Bil Bbls	(%)	
New Field Discoveries (adjusted for expected growth)	2.497	18	
Reserve Growth from Existing Fields	11.070	82	
Extensions & Infill Drilling	9.330		69
New Pool Discoveries	0.845		6
Adjustments	0.895		7
Total	13.567	100	

Source:
Kuuskra, V.A. et al, "Replacement Costs of Domestic Oil and Gas Reserves," paper presented to Society of Petroleum Engineers Conference, New Orleans, La., October 1986.

What would be the effect of the Windfall Profits Tax under alternative future price paths?

Recent studies at API have examined the potential for the effect of the tax under several alternative price paths based on the recent Energy Security study by the U.S. Department of Energy.

In Exhibit 5, the future effects of the tax are estimated under two alternative price scenarios. In the first case, we examine the effects of the tax under the DOE "high price" scenario in which prices rise gradually from $17 per barrel in 1987 to $27 in 1995. For a price elasticity similar to that realized in 1980-85, the tax results in the loss of over 800 million barrels of domestic crude oil reserves over the next decade, which would be developed in the absence of the tax. More significantly, if prices should rise $10 per barrel above that price path, the disincentive effect of the tax triples, as more than 2.4 billion barrels of reserves are not developed during the next decade due to the tax.

The reason for the sharp increase in the impact of the tax is that the average rate of the WPT rises sharply as price rises above the statutory base price in each tier. In the first case, the WPT is binding only on Tier 1 oil between 1989 and 1993, and at its peak reaches 14%. In the second case, a $10 increase in price raises the peak Tier 1 tax rate to over 30%, in addition to reinstating taxes on Tier 2 and Tier 3 oil.

While subject to a great deal of uncertainty, the WPT remains a significant threat to development of future domestic production capacity under a very plausible range of circumstances. Furthermore, it should be emphasized that all of the cases examined in Exhibit 5 assume that the tax is phased out on schedule. Should it be retained, or should producers anticipate that it will not be phased out, the effects could easily be several times larger than estimated here.

These results illustrate clearly the perverse nature of the future effects of the tax. That is, its disincentive to domestic supply is likely to increase sharply in precisely the circumstances in which such supply is most needed, namely in a tightening world oil market.

In summary, much of the damage from the Windfall Profits Tax has already occurred. Because of the tax, U.S. production today is over 800 thousand barrels of crude oil per day less than it would have been if the tax had never been imposed. Nevertheless, repeal of the tax will have significant positive effects on the development of future domestic production capacity. Even in cases where price recovery is modest, repeal would induce significant reductions in the rate of decline in domestic oil production, with the significance of this effect increasing with the price of oil. Far more importantly, however, repeal of the tax would remove a serious impediment to the development of an effective domestic supply response to the expected tightening of world oil markets in the 1990's.

Exhibit 5. Effect of WPT Repeal on U.S. Gross Reserve Additions of Crude Oil, 1987-1997
(billions of barrels)

	Price Elasticity of Gross Reserve Additions		
	0.7	1.1	1.6
Case 1: DOE "High Price"	0.5	0.8	1.2
Case 2: DOE "High Price" plus $10/bbl after 1990	1.4	2.4	3.7

Mr. DiBona. We had surveyed the companies early last year and asked them how much production they expected in one year and five years as a consequence of different price levels, and at $15.00 a barrel, we anticipated a drop to 2.7 million barrels a day in five years, from 8.9 to 6.7. That is consistent with Dr. Fisher's comments earlier. Not quite as steep but in the same general ballpark.

When you start applying those same numbers to the windfall tax, you just get much bigger numbers quoted here.

The petroleum industry has paid federal taxes at a higher rate than other industries, even without the windfall profits tax. Repeal of this special tax would help ease the heavy burden and would encourage the economically distressed industry to renew the development of these supplies.

A number of other provisions of current tax law should also be changed to remove impediments to exploration and development. In particular, API recommends current expensing of geological and geophysical costs, current expensing with intangible drilling costs for all producers, repeal of the property transfer rules regarding percentage depletion and windfall profits tax, repeal of the income limitations on percentage depletion, repeal of the Revenue Rule 77-176, removal of intangible drilling costs and percentage depletion as alternative minimal tax preference items. Removing these are an important step to a greater energy security.

What is needed in addition are positive measures that would directly stimulate domestic production and exploration. One such measure is an oil and gas exploration and development credit. Such a credit, while stimulating domestic petroleum activity, would not raise oil prices, would have no inflationary impact, would have a positive effect in our balance of trade, and properly targeted, it would reward only future activity.

In conclusion, Mr. Chairman, we believe these hearings are a constructive step toward dealing with this country's future energy security, and we applaud your holding them.

Senator Boren. Thank you, Mr. DiBona.

Mr. Stafford, the Executive Director of the National Association of Royalty Owners and we would be very pleased to hear from you at this time.

[The prepared written statement of Mr. DiBona follows:]

STATEMENT OF THE
AMERICAN PETROLEUM INSTITUTE
and
MID-CONTINENT OIL AND GAS ASSOCIATION

The critical decline in U.S. oil and gas development over the past two years has been well documented. In testimony submitted to this Committee on January 30, 1987, API noted that the precipitous oil price fall has set in motion forces that, if unchanged, will greatly increase U.S. dependence on foreign oil, strengthen the cartel power of OPEC, and have serious adverse economic and national security consequences. Energy security was the focus of the Department of Energy report submitted to the Congress by the President on May 6. In his letter to Congress the President noted three major concerns arising from that report: (1) our increasing dependence on imported oil; (2) the sudden decline in oil prices in 1986, which has harmed significant segments of the U.S. petroleum industry; and, (3) the serious implications for national security raised by both of these events. Although prices have recovered somewhat, at least for the moment, the situation remains tenuous. This statement will focus on some of the positive actions the Congress should take to promote renewed drilling and safeguard national security.

Repeal the Windfall Profit Tax

First, we strongly urge Congress to act promptly to repeal the Windfall Profit Tax (WPT). This excise tax was enacted to capture a portion of the so-called "windfall" price increases resulting from decontrol of domestic oil prices. Generally, the so-called windfall profit element is the excess of the sale price over the adjusted (for inflation) base price. There are several important reasons for repealing the tax now: it is a disincentive to domestic production; it imposes heavy administrative cost on taxpayers and government even though it generates little, if any, revenue; it is an ill-advised tax on an already heavily taxed industry; and there are no "unearned profits" from decontrol to be taxed -- thus, the underlying rationale for the tax is no longer appropriate.

(1) The WPT is a disincentive to domestic production.

Although the WPT receipts -- as reflected by total payments -- have been much less than what was originally estimated, the tax has nonetheless represented a significant disincentive to domestic exploration and production. And, even though under current depressed industry conditions little or no WPT is being levied, the tax poses a disincentive to both present and future investment because it limits the potential profitability from any future increases in oil prices.

The negative influence of the WPT occurs in two ways. First, the WPT imposes an economic disincentive on future production, thus making many new domestic oil exploration and production projects unattractive. For example, more intensive development of existing fields (e.g., infill drilling, secondary recovery operations, pressure maintenance operations, and workovers) is especially sensitive to the WPT. These projects have offered and continue to offer the best opportunity for near-term supply response.

According to a study released May 18, 1987, by the Petroleum Industry Research Foundation, Inc. (PIRINC), development drilling accounts for more than 80% of all wells drilled in the U.S. Over the period 1979-85, the combination of revisions, improved recovery, and extensions of existing reservoirs accounted for almost 90% of the additions to proved crude oil reserves in the U.S. Put another way, development drilling in older reservoirs was far more important to the U.S. reserve position than new discoveries. The study concludes,

> "The WPT, taking up to 70% of incremental revenue, will clearly hamper the economics of drilling in any Tier One property. Since development drilling in older fields would have been the first to begin again, the tax will limit the relief which the drilling sector will get from rising prices. Production will be dampened in turn by the lack of development drilling."

Thus, continuation of the tax would result in less domestic production and an inevitable increase of oil imports.

Second, because of the high risk nature of the business, internally generated cash flow, rather than borrowings, must provide a major source of exploration and production capital. This cash flow is generated largely by income from existing production (e.g., Tier 1 old oil). The PIRINC study cites an Arthur Andersen & Co. compilation of information from 375 publicly traded companies which indicates that in the period 1981-85 the petroleum industry reinvested 70% of its production revenue in upstream activity. The smaller "independent" companies in the sample financed drilling with debt, so expenditures exceeded production revenue. Since in today's environment and over the foreseeable future any WPT that is due will be from Tier 1 crude oil, the WPT, by extracting the largest cash-flow penalty from Tier 1 old oil, substantially decreases the pool of capital available to fund exploration and development of the principal source of domestic reserves. A barrier is thus erected to new investment on Tier 1 properties and otherwise recoverable reserves are left in the ground. The trend toward shutting in wells is exacerbated by continuation of the tax. Repealing the WPT would do away with these artificial distinctions and reduce such misallocations of resources.

(2) WPT imposes heavy administrative costs even though it generates little or no revenue.

API estimates the current annual cost of compliance to taxpayers is approximately $100 million, exclusive of audit costs. This cost to taxpayers is in addition to the cost to government. The IRS estimates that last year alone it processed 4 million original Forms 6248, which must be produced and filed for all transactions even if no WPT is due. It is simply a drain on public funds to continue a tax that costs the government more to administer than it returns in revenues.

Moreover, for the years in which the WPT has been in effect, taxpayers and the government have struggled to resolve complicated legal and accounting questions. Unfortunately, far too many of these questions still are unresolved. This tax has turned out to be much more complex and require many more filings from many more taxpayers than was envisioned at enactment.

There is also the confusion that continues to exist because DOE pricing and allocation regulations were used as the basis for many features of the tax. In addition to the confusion inherent in applying now otherwise defunct DOE concepts, further confusion and perverse results occasionally arise from the fact that often the DOE regulations were issued to achieve an entirely different goal from that of the IRS.

Finally, there is the cost to the government of time devoted to regulations projects. Not only is there substantial time spent in drafting regulations, but even more time is spent as the IRS staff tries to revise them in response to public comments. Taxpayers bear a similar, if not greater, cost as they attempt to comply with regulations or furnish the IRS with explanations of why an approach should be modified. While repeal of the tax will not immediately eliminate these problems, it will bring them to an end sooner.

(3) A special tax on the economically distressed petroleum industry is ill-advised in light of energy security concerns and the heavy tax burden the industry already bears.

The petroleum industry's rate of federal tax payments has been as high or higher than that of non-oil industries even in the absence of the WPT and much higher if that tax is included. Futhermore, if Joint Tax Committee estimates of additional burdens placed upon petroleum in particular and industry in general are correct, the oil industry's federal income tax burden can be expected to increase even further under the Tax Reform Act of 1986. That provides an additional reason for repealing the tax. In testimony before the Finance Committee February 4, 1987, J. Roger Mentz, Assistant Secretary of the Treasury, noted that the Tax Reform Act was "...designed to produce uniform rates of taxation on the income generated in different activities, and to eliminate tax-induced distortions in investment. Repeal of the windfall profit tax is consistent with that objective."

(4) The tax has served its original purpose; there are no "unearned profits" from decontrol to be taxed.

When President Carter announced his plan for phased decontrol of domestic crude oil prices on April 5, 1979, he also proposed a tax on the "windfall profit" of producers and royalty owners to "...prevent unearned, excessive profits which the oil companies would receive as a result of decontrol and possible future OPEC increases...".

The original purpose of the WPT has been achieved--a substantial portion of the revenues from decontrol has been captured by the federal government. However, since the precipitous decline in crude prices, the prices have dropped below the controlled ceiling prices that would have existed had price controls still been in effect. There are simply no "unearned, excessive profits" to be captured.

Since President Reagan accelerated and completed decontrol in 1981, domestic crude oil has been produced and sold in direct competition with crude oil from other producing nations. Domestic crude oil prices have been determined by the forces of the world market. Because the market in which the domestic petroleum industry now operates is working, with prices both rising and falling in response to supply and demand, there is no reason to continue the tax surrogate for the price controls in effect a decade ago. That the market works is shown by the price collapse which occurred when worldwide production exceeded worldwide demand. Continuing the WPT disadvantages the domestic petroleum industry without accomplishing the purposes for which it was enacted.

These circumstances have been recognized by the Administration. As stated by Assistant Treasury Secretary Mentz in his February 4, 1987, testimony, "Even if crude oil prices again rise to levels that would generate significant profits for domestic oil producers, such profits would, in no way, be considered 'windfall' profits. This is because a return to a profitable situation for domestic oil producers would be the result solely of market conditions (here and abroad) and not the result of the government lifting an artificial price barrier, as was the case when the tax was first imposed."

Conclusion

The WPT is contrary to the national interest and should be repealed immediately. It discourages investment in domestic petroleum production at a time when dependence on foreign imports is rising rapidly. It constitutes an additional tax burden on an already heavily taxed industry. Even under present distressed industry conditions when the tax generates negligible revenues, it continues to impose heavy compliance and administrative burdens on both taxpayers and government. And, it has served its purpose of capturing a portion of the incremental revenue associated with the decontrol of domestic crude oil prices. There are simply no "unearned profits" from decontrol to be taxed.

If investors are to respond correctly to changes in petroleum market conditions, artificial impediments such as the windfall profit tax must be removed. In particular, if the nation is to benefit from the full potential increase in domestic supply in response to any future price recovery, the result of that price rise must be permitted to flow through to the industry to fund replacement of domestic reserves.

The cost of exploring for and producing crude oil is likely to continue to increase, especially since the best prospects for new domestic reserves are generally in difficult or hostile environments such as Alaska or deep-water Gulf of Mexico or in small, geologically difficult reservoirs. Removing an impediment to investment such as the WPT will be an important initial step towards slowing reliance on imported crude oil.

Other Tax Provisions

There are other tax provisions that hinder the exploration for and development of domestic reserves and which should be modified.

1. Geological and Geophysical Costs

Geological studies and geophysical surveys (G&G) are the initial steps in evaluating an oil and gas prospect. The costs of core drilling, seismic studies and other G&G activity are incurred for the purpose of ascertaining the existence, location, extent and quality of any deposit of oil or gas. Currently, expenditures for G&G are recovered through cost depletion over the life of the field. Under today's conditions, oil and gas exploration is being carried out in increasingly hostile environments and at increasingly higher costs. Geological and geophysical costs are an important and integral part of the exploration process on a daily basis and, as such, represent ordinary and necessary business expenses. Spreading their recovery over the life of the field results in little or no benefit on a present value basis because of the long lead times which characterize oil and gas development. They should be allowed as a current deduction.

2. Intangible Drilling Costs

Under present law, integrated oil producers may deduct only 70% of intangible drilling costs (IDC) in the year incurred; the remaining 30% is amortized over a period of 60 months. Independent producers may currently deduct 100% of IDCs. The current expensing of IDC as incurred is by far the most efficient cost recovery mechanism. Current expensing avoids reduction of anticipated rates of return of any project below pre-tax levels and the resulting creation of barriers to investment in oil and gas production. At the same time, it does not impose any long-range reduction in tax revenues. Full expensing of IDC should be available to all producers regardless of size.

3. Rev. Rul. 77-176

Under its strained interpretation of existing law (see Rev. Rul. 77-176) the Treasury causes taxpayers to use the cumbersome tax partnership rules in order to obtain traditional after-tax economics of typical oil and gas joint ventures. Eliminating the unnecessary, multifarious burdens of Rev. Rul. 77-176 (e.g., partnership tax returns, separate audits and administrative proceedings) would be beneficial to both taxpayers and the IRS.

4. Transfer Rules

Under current law when an independent producer acquires a "proven" producing property from an integrated producer, that property is not eligible for percentage depletion or for the stripper well exemption under the Windfall Profit Tax. Repealing these transfer rules would enhance energy security by removing barriers to transfers of properties from one taxpayer to another who can operate them more efficiently. Absent such a change, the properties might well be abandoned as uneconomic, rather than produced.

5. Net Income Limitations

Current law provides that the percentage depletion deduction is limited to not more than 50% of the net income of an eligible producing property and not more than 65% of the taxpayer's taxable income. Repealing these provisions would stimulate additional cash flow to those independent producers who still have income producing properties.

6. Minimum Tax Preferences

Intangible drilling costs and percentage depletion should be deleted as preferences for the individual and corporate alternative minimum taxes.

Tax Incentives

Repeal of WPT and modification of existing tax provisions that hinder the U.S. energy position are principal and important steps toward greater energy security. What is needed in addition are measures which would directly stimulate domestic oil and gas exploration and development.

Tax incentives aimed at increasing investment in new exploration and development and in enhanced recovery of already discovered reserves would serve to mitigate the negative effects of changes in tax treatment of the industry over the past several years. One such measure is an oil and gas exploration and development credit, applicable against both regular income tax and the individual and corporate alternative minimum taxes. Such a credit would stimulate domestic petroleum activity and begin to reduce our increasing dependence on insecure foreign oil. It would not raise prices, would not increase inflation and would have a positive effect on our international trade position. Furthermore, it would reward only future activity thus stimulating domestic exploration and development activities. We would be pleased to work with the Committee on development of such a credit.

This Committee has correctly recognized that if the U.S. expects to limit its dependence on imported oil from insecure foreign sources in the next decade and beyond, new policies must be put into place now to develop an investment climate that will revive and stimulate the domestic oil and gas industry. We urge the Congress to move forward.

WOR-20

STATEMENT OF JAMES STAFFORD, EXECUTIVE DIRECTOR, NATIONAL ASSOCIATION OF ROYALTY OWNERS, ADA, OK

Mr. **Stafford.** Thank you, Senator Boren.

I represent about 5,000 members of the National Association of Royalty Owners, which is based in Ada, Oklahoma and not, as on the program, in Washington. We also act on behalf of 38,000 members of regional, county and State mineral and royalty owner associations affiliated with our group. I, myself, in addition to this, am a farmer and a rancher. I manage some trust properties with Royalty income and I am a consultant to several colleges.

Senator **Boren.** The chair will definitely correct the record to show that that association is located in Ada, Oklahoma.

Mr. **Stafford.** All right. [Laughter.]

I think that would be good for you and for me.

The royalty owners personally owns all or a portion of the mineral rights in producing wells, usually the latter. The historic share of production has been one-eighth and in some parts of the country three-sixteenths. The royalty owner, in terms of age and income, was hardest hit by the windfall profits tax. We were victims of misconceptions that have since been clarified by research that was initiated in large part by Senator Boren and Senator Bentsen.

The royalty owners lost from the windfall profits tax an average of 38 cents from every dollar on a tax base of from 30 percent to 70 percent. That was the highest tax ever levied in the nation's history against an individual group.

Of the nation's 2.5 million owners of producing minerals, a majority has suffered extreme hardships since that tax. It has prevented planning for the future. It has sidetracked many medical needs. It has also added the cost of extremely high legal and accounting expenses. Those problems have now been compounded by a drop in crude oil prices, which has cost an estimated minimum of $6 billion in royalty income loss in the past months.

Hardest hit by the windfall profits tax has been the rural and agricultural sectors, already under the worst economic shakeouts since the heart of the depression. Royalty income helps thousands of farm-ranch operations survive. Approximately 27 percent of royalty owners live or work on farms and ranches. Today, those are also failing. Within 30 minutes drive of my home, right now there are 300 farms and ranches for sale. Chances of them selling are next to nil.

The windfall profits tax also triggered thousands of shut ins among economic wells, now lost forever due to water migration. I lost three marginal wells in Texas within six months after the tax was passed that will never produce again.

It also initiated an erosion in farm-ranch values in the agricultural sector. That runs as high as a 60 percent drop in Southeastern Oklahoma and parts of East Texas. The tax created a tyranny of uncertainty and fear of errors that account for an estimated 40 percent of the royalty owners not filing for exemptions. This was verified with Phillips Petroleum, who ran some numbers for us just this last week.

The average profile of a royalty owner is over 65 years of age, a widow, living in a rural community, with a monthly royalty check of under $200.00 supplementing social security. We are largely unsophisticated and without the expertise to understand most compliance requirements.

Outside of the core producing States—Oklahoma, Louisiana and Texas—it is impossible to secure professional advice needed for compliance, both with the tax and its exemptions. Even in producing States, well run income triples charges for tax accounting because of the windfall profits tax. We cannot afford this expense. And many of our elderly have also been intimidated by fears of audit and rumors they will lose their social security if they file incorrectly, and, thus, they do not file.

Royalty owners are dependent upon a strong domestic industry; They are thus hopping mad over the kamikaze energy policy of our government. We cannot conceive that the Administration and Congress ignores the national security implications by consideration of further taxation and over-regulating the domestic industry to its grave while, in a sense, encouraging further imports.

Wells not drilled and wells abandoned pay no taxes. Royalty owners of domestic production pay windfall profits tax, federal and State income tax, State severance and ad valorem taxes on their production. We believe that repeal of the windfall profits tax still leaves us doing our fair share.

As an example, we have a member in East Texas that, after the windfall profits tax, he had 13 cents left out of every dollar of income.

Our people believe that the windfall profits tax, as much as OPEC, triggered the current collapse of the domestic independent oil industry. That view has been supported by many oil and gas economists in recent years.

Until its repeal, leasing and exploration remain deadlocked, and royalty owners will be reluctant to lease at any price.

Thank you.

Senator Boren. Thank you very much, Mr. Stafford. And I think it is always good to put in the record again the profile of the average royalty owner because I think many people in the Congress who thought they were involved in taking money out of deep pockets did not realize exactly the kinds of people who are genuinely royalty owners. And very often that is retired people, widows of farmers who originally owned the surface, and kept the minerals as a retirement program, and most of them with low incomes and very small royalty checks, as you said, supplementing social security. And they have been damaged severely. And I thought particularly interesting were those statistics on the number that, probably because of the lack of understanding and technical advice, did not file for the refunds to which they would have been eligible.

Mr. Robitaille is the Executive Director of the Petroleum Association of Wyoming. And let me say that Senator Wallop had hoped to be here today and had discussed your testifying with me. He had an unavoidable conflict, and we will leave the record open to receive a statement by Senator Wallop that he especially asked me to express to you his regrets of not being able to be here. We will hear from you at this time.

[The prepared written statement of Mr. Stafford follows:]

Testimony of
James L. Stafford,
Executive Director of
The National Association of Royalty Owners, Inc.

Mr. Chairman and Members of the Committee:

May I thank the committee for the chance to present some facts about royalty owners and how they have been impacted since the inception of the Windfall Profits Tax.

I also will briefly address how this government's current kamikaze energy policy is a national disgrace. And also how royalty owners feel about the recent Department of Energy Report, which we consider the biggest fairy tale since Aesop's Fables.

My name is James L. (Jim) Stafford, I represent about 5,000 members of the National Association of Royalty Owners, which is based in Ada, Oklahoma. We also act on behalf of 38,500 members of regional, county and state mineral and royalty owner associations that have affiliated with our group. We were formed in 1980 in opposition to the Windfall Profits Tax. Since then, we have gathered data and conducted research on a wide range of topics involving the rights and fair treatment of mineral and royalty owners throughout the nation.

As a group, royalty owners have been financially riddled by tax actions arising from misconceptions. In years past this has not been confined to Congress. Throughout the years we have been stereotyped repeatedly in a negative and false manner by non-oil-state media, ranging from "The Beverly Hillbillies" to recent soap operas dealing with a mythical Texas family.

Simply put, a royalty owner is a person who owns all or a portion of the mineral rights beneath a producing well, usually the latter. His or her share of production was traditionally one-eighth, and in recent years, in select parts of the country, this has risen to three-sixteenths.

Studies by Phillips Petroleum on our behalf show a minimum of four royalty owners under each well. In Senator Boren's home county, there are often three to four dozen -- on average.

We are not, as widely perceived, folks totally confined to Louisiana, Texas and Oklahoma. In fact, one estimate is presented that less than one-half of the nation's royalty owners -- slightly over 1.2 million of the total -- are living in those states.

Less publicized producing areas exist also with healthy numbers of royalty owners.

California has 300,000, Ohio contains 80,000 , West Virginia has 56,000, Pennsylvania numbers over 100,000. Non-producing centers of migration, such as New York, Chicago, Boston and even Washington, D.C, have heavy concentrations also.

The total, for the nation, exceeds 2.5 million people who receive these fractional interests of production from oil wells.

Royalty owners of the nation have suffered two enormous set-backs in recent years. First, when the windfall profits tax was passed, the average tax withheld from their producing interests averaged 38 cents for every dollar of income. We were taxed at the same rate as the major oil companies -- the prime target of that vicious legislation. We could not pass along that tax. They, in most cases, offset it with foreign income, and internal diversification.

In addition to that tax, the royalty owner pays his federal and state income tax, gross production tax and in many cases ad valorem taxes on that income. To one NARO member, based in East Texas, this left 13 cents from every dollar of income.

Next, we have suffered the enormous impact with the recent oil price drop. Each $1 drop from the high price of $35 was said to cost Oklahoma royalty owners $17 million, those in Texas $41 million, Louisiana $10 million, Kansas $14 million, New Mexico about $5 million and Arkansas $2 million.

Using other data as a base, NARO estimated that the drop from $26 per bbl. to $16 per bbl., extended to one year, displaced $3.8 billion in lost income nationwide.

While that might seem a drop in the bucket to a federal bureaucrat, it has hit the argicultural sectors of the nation, where royalty income is often a vital adjunct to farm ranch operations, in terrible ways.

For example, we have an erosion in land values in Southeastern Oklahoma of between 40 percent to 60 percent since 1980, according to the Oklahoma Farm Bureau. Within 30 minutes of my home, there are over 300 farms for sale. None are selling. There is simply no money.

This does not account, either, for the loss of stripper well production, which accounts for the bulk of royalty interest owners of the nation. Those wells, doing less than 10 bbls. daily, account for over 60 percent of the production in such states as Kansas, Oklahoma, Illinois, Arkansas, Ohio, Kentucky and Tennessee, to name a few. In Oklahoma alone, we may have lost 19,000 stripper wells in past months, although the count is not yet in. Those wells are lost forever, since water migration takes them over, and in effect, they are unrecoverable. Shut-in and abandoned wells pay no royalties, and they also pay no taxes.

That's today. When the Windfall Profits Tax was passed, I lost production from three small wells in Texas that I'd purchased from an elderly relative. They were simply classed as too marginal to produce. Those are gone forever from the tax rolls.

My personal royalty income -- my only form of investment — is down over 85 percent since 1983, courtesy of government action.

In my county alone, where the average production is less than three bbls. daily, we're in the process of losing over one-half, or nearly 4,000, of our oil wells. One independent producer, Mike Cantrell, predicts this has accounted for the loss of 533 jobs in the county (pop. 30,000). It has already, from abandonments, cost a loss of $8 million in revenue. This is revenue gone forever, and also off the tax rolls.

A study of spending habits of royalty owners in Texas gives us an indication of where this royalty income goes. The first priority is for taxes, food, medicine, health care, home upkeep. Second, and in this order, is for retirement of farm or home mortgages. Thirdly, it will be spent on farm equipment or home improvement. Fourthly, it was earmarked for education or such provisions for kin. Fifth, it goes into investment or savings. It should be noted that royalty owners, in historical accounts, were the first source of drilling seed-money for wildcatters and independents.

How, you ask, did these people acquire those rights? The major methods of acquisition include 1) purchased with the surface rights, 2) inheritance, 3) taken in lieu of debt or for labor owed, 4) as an investment (it was our blue-collar stock exchange), and 5) as production shares for potential retirement income. Royalties have long been a source of barter and freely exchanged for needed goods as services -- now most of that is assigned to lawyers and accountants, as I'll show later.

We have little control over our destinies after a lease is signed. That's why our fate is closely linked to the producer-operators, which in our part of the country are not the major companies, but the now-dwindling fleet of independent producers, whose chances of a producing well are less than 1 in 10.

The Windfall Profits Tax, aside from its negative economic impact, generated fear. It was a fear to drill or invest for many. It was a fear that the federal government, acting on a whim, would lash out once again and tax the royalty segment of the population without warning. This fear has prevented long-term planning, waylaid needed medical expenditures, generated unwarranted legal and tax advice, and left in shambles the lives of those who, for the most part, simply wanted to spend the remainder of their life on earth in dignity. Most of us now are too poor to paint and too proud to whitewash.

Regardless of OPEC pricing, I firmly believe that history will prove the Windfall Profits Tax was the single blow that triggered, possibly forever, the end of domestic oil and natural gas producing sector of the United States.

That tax prevented long-range accumulation and planning by both royalty owners and producers to survive such a price drop as recently witnessed. The only people, incidentally, that predicted those high prices were here forever, were government economists and a handful of energy experts perched on the oil rich shores of the Chesapeake Bay.

That tax, history will prove, should have been levied against the Persian Gulf and not against the domestic producing sector. And that view is shared by most of our members.

Let's look for a moment at the tax and why it must be repealed, regardless of the current state of the industry and the tax lust of the House of Representatives.

First, the vast majority of those impacted are those least able to understand and deal with the complexities of both the law and the IRS regulations dealing with compliance.

Here's the profile of the average oil royalty owner:

* Over 65 years of age
* Widow
* Living in a rural community
* Average run check under $200
* Royalties supplement social security income
* Unsophisticated and without the expertise to understand most tax compliance requirements
* Does not have access to informed professional advice
* Does not understand or trust most communications sent out by pipeline-purchasers
* Is intimidated by federal tax requirements and fears (rightfully or not) government reprisals for errors or a possible assault on their social security income

We fought for and, of course, were pleased with, every step of exemption won for royalty owners through the efforts of several members of this committee. However, its implementation has proven a page from Dante's "Inferno". Several oil companies, for example, have estimated that as many as 40 percent of those entitled to exemptions have never taken them. Here's some of the reasons why:

1. The complexities of the exemption were too burdensome and required use of a costly oil and gas tax accountant.
2. Accounting fees, according to a Lubbock oil and gas accountant, normally triple for the individual with oil royalty income since the WPT passage. A gas royalty owner can have a return prepared for as little as $200. The same person with oil income, could pay as much as $600 to $800, far in excess of the amount retrievable for most royalty owners.
3. The IRS rules are so complicated that a great many people, estimated as high as 40 percent, are afraid to file for the barrel exemption, and thus their money could be held by the government for as long as 19 months before they get a refund, even if they're entitled to the entire amount of WPT as a refund for overpayment.
4. IRS rules allow the oil companies until April 1 to furnish forms necessary to file individual tax returns. This effectively prevents many royalty owners from filing their returns by April 15. Even if an exemption certificate has been filed, and no WPT is being deducted, you cannot file a return without including those documents.
5. Elderly, rural people, who account for the large portion of royalty owners, have a basic fear of coming under the scrutiny of the IRS. The common myth during the first bbl. exemption was that if you

made a mistake, they would audit you for years back and somehow take away your social security. This myth was heard over Texas, Oklahoma and parts of Kansas. It is not a pleasant picture. They thus refused to file for their exemptions because they feared either they, or the tax preparer, would make a mistake.

6. Individuals living in non-producing states do not have access to tax preparers who understand how to file for overpaid WPT. Many preparers refuse to try, both in producing and non-producing states. And the unsophisticated and elderly on limited incomes who must depend upon franchised store-front preparers or attempt their own because of the cost involved, many never get the benefit of the exemption.

7. Trying to figure out the instructions (or the lack of them) for tax preparation can become a nightmare. Although the WPT has been in place since 1980, there is still no line on the 1040 form to show overpaid WPT. Further, the instructions for completing Form 6249, Computation of Overpaid Windfall Profits Tax, is so complicated that oil patch CPA's have difficulty. The 75-year-old Pennsylvania widow whose returns are prepared by H & R Block simply cannot cope with such problems.

   (I defy any one who is not an oil-patch CPA to comprehend the four pages of fine-print instructions attached to what looks like a very simple Form 6249. (attached))

8. What percentage of royalty owners have never benefitted from the tax credits and exemptions allowed? If they don't live in Texas, Oklahoma or Louisiana, the percentage is probably very high, but

even oil patch residents are at risk.

Phillips Petroleum told one of our offices that only 27 percent of their over 60,000 royalty owners filed exemption certificates. We must factor in those with multiple properties who chose to claim exemptions at the end of the year, but 40 percent, again, is a good estimate of the number, through ignorance or fear, do not claim exemptions.

For example, a Texas CPA tells us the story of a man who lives in a small town outside Borger, Texas. He was an oilfield welder who owned some land in Oklahoma with some oil production on it. He used the services of a tax preparer in his home town. Because this preparer didn't understand the process for WPT claims, the man didn't get either the 1980 and 1981 tax credits or his 1982 barrel exemptions. Luckily, he changed tax advisers before the statute of limitations ran out, and was able to recover almost $5,000 in overpaid windfall taxes. Most others are not that lucky, and the mistakes are never discovered.

9. There also is the problem that the oil companies' inability to administer this complex tax creates additional financial burdens for royalty owners in the form of repeated filing of amended returns because of withholding errors. It could cost them $600 to get the original return filed, and anywhere from $100 to $300 each time they are required to file an amended return, plus any penalties or interest that may have accrued. In some cases, royalty owners have been required to file as many as three amended returns for a single year. Not because of their errors or their

accountant's errors, but because of inaccurate information provided by the purchasers.

Further, there are still many inequities in the WPT exemptions:

1. Owners of overrides negotiated in their lease in addition to regular royalty (a common practice in earlier years) are not allowed exemptions on those overrides. Thus, the royalty owner who has a 1/8th royalty with a 1/16th override is not allowed the exemption on a third of his royalty income.

   Many lease forms still have blanks that signify any royalty over one-eighth is an override, while in industry usage it is a simple royalty, sometimes called "excess royalty."
2. Meeting the very strict limitations on eligibility for the exemptions is very difficult for most family farm corporations, even though the law says they are qualified. One CPA who deals almost exclusively with rural clients says she has yet to see one that will qualify.
3. If a single woman having royalty income marries a man with royalty income, they must share the 3 barrel exemption even though their properties are separately owned. And if they have minor children who inherit, say, from a grandparent royalty rights in their own names, that same 3 barrels must now be allocated among all the family members.
4. Beneficiaries of royalty trusts, although eligible for the exemption, are not allowed to file an exemption certificate, but must wait and claim the exemption at the end of the year, thus

delaying for several months the use of the income.

The WPT was passed at a time of emotion. It was unwise and a very bad law. Today, as long as it's on the books, it remains a spectre hanging over every aspect of the domestic energy business.

The only people making plans today are those with giant stakes in the international picture. Our one ray of hope was that the recent Department of Energy Report would paint a realistic picture on the need for an import tax.

They did not elect to do so. Instead, they reaffirmed the buzz-words of economic platitudes so dearly loved today by people in high places. Buzz words need modifiers. Without those, they are overly simplified labels that mislead as well as clarify. Buzz-words were used by the Nazis to great advantage. By Stalin as well. And they were also used to incite the crucifixion of Jesus Christ.

Our government, in the name of one of these buzz words, free enterprise, refuses to tax those whose power has us at their mercy. In the early 1980's, there was no such restraint in taxing our own people into bankruptcy. Free enterprise presupposes free men operating in a free market. Our OPEC allies are not part of that equation, yet their market priorities seem to have been placed above those of our domestic industry.

We are told by our northern cousins that cheap energy should somehow be the birthright of our citizens. They indicate it should be the consumers that set the price, with little regard for supply and demand. Rural people, too, would like that birthright. If so, we would demand things like a $10,000 tractor and a $3,000 pickup truck, instead of the $70,000 for the former and $12,000 expected for the latter. The factories, of course, and their stockholders, could be expected to pay the cost. This would not be taken seriously, yet Congress salutes when consumer groups advocate 60-cent gasoline or a continuance of natural gas prices at far below replacement costs. This pays homage to exactly the same scenario. Frankly, something is haywire.

We have seen our banks fail in record numbers, our independent producing sector riddled to shreds, our royalty owners forced to sell their farms and go on welfare to satisfy farm-ranch debt and we have seen wells shut in years ahead of their time under the current so-called national energy policy.

In 1982, a widow from my county testified before the House Ways and Means Committee. She was a small royalty owner.

In that testimony, Vera Barrick stated her greatest fear was to be put into a nursing home and be supported by the government.

She said: "I've worked hard all my life. I don't want to live with my kids. And I can't understand why the government thinks they have rights to everything I've got. I make my own clothes, and my royalty checks go for food, medicine and insurance."

She said her car was broken and wouldn't get fixed because of the expense. She had just had a cataract operation, the last of three bouts of surgery in recent years. She said if there were a place in the state that would train and employ the sick and elderly, she'd hold two jobs.

Her royalties, inherited from her father, who had received them in lieu of oil field labor, were then over $100 a month. The tax reduced it to $60. She called that a lot of tax for herself and her friends who lived on royalty and social security.

Early this year, Vera Barrick's worst fears were realized. She is now in a government subsidized nursing home. Her wells were shut-in as uneconomical during the price drop. They have been permanently abandoned. The government now pays for her needs. She is in her mid 70's.

Another widow, slightly less in years, has producing minerals in Western Garvin County, Oklahoma. The income is now down to about $150 per month.

Her small business failed during the collapse of the drilling industry. She is trying to sell the minerals to square debt and looks forward to buying a small grocery store in a rural town to live out her life.

She is unable to sell at any price near the market value of $4,000. A Wisconsin buyer said the paperwork on such small acreage wouldn't be worth it. Two producers have declined it as "more trouble than its worth." A trust manager has also disclaimed any interest. All have expressed that under current laws and uncertainty, they simply were going to stay on the sidelines.

Those are the fruits of taxation under our so-called national energy policy.

Even as many producers were going down for the third time, Congress was burning the midnight oil trying to destruct the percentage depletion allowance, possibly at the time it was most badly needed.

The distinguished statesmen in this room, as with your last year's efforts to repeal this tax, may mark the last life raft in the nation for the domestic industry. What is needed is confidence. You hold it in your hands. Please repeal this mistake and help take the first step back to sanity for an industry vitally needed for the security of this nation.

We have been promised repeal of the WPT, almost since its passage by the current Administration, and by many of our elected statesmen in both the Congress and the U.S. Senate.

I believe that unless this is repealed, the needed confidence to restore some life to the domestic industry may never come. Wells not drilled pay no taxes. The cost of imports in military vigilence now far outweighs any future gains. The administrative burden for government may also be expected to far outweigh compliance benefits of this unfair law.

For royalty owners this amounted to the largest single tax in the history of the nation against one select group. Those it hurt most were those least able to afford it. We feel this, along with much of our national energy policy, seems more shaped by soap operas than the economic lessons of the past decades. Set it straight, while there may still be a second or two of time left.

STATEMENT OF RICHARD T. ROBITAILLE, EXECUTIVE DIRECTOR, PETROLEUM ASSOCIATION OF WYOMING, CASPER, WY

Mr. ROBITAILLE. Thank you, Mr. Chairman. I am pleased to be here, and appear before you on behalf of several hundred independents and individuals and companies and corporations involved in the oil and gas industry in the Rocky Mountain public land States. The association maintains a membership that accounts for more than 90 percent of the production and 90 percent of the wells drilled in the Rocky Mountain States, a large share of which is in Wyoming, which is a significant producing and exploration State in our country. We are presently sixth in production, fifth in reserves of crude oil, and sixth in reserves of natural gas. As such, we have not escaped the unprecedented declines that have been witnessed in your State and some of the other States represented here.

The impact on our industry has been significant. In 1986, we had one of the lowest years for active drilling rigs that we can find in the recorded history of the industry, and, unfortunately, thus far through the first quarter of 1987, we are 60 percent below that level. So we are in desperate trouble. That, consequently, is affecting the rest of the State which relies very, very heavily on the oil and gas industry. At the present time, we account for roughly 60 percent of the value, taxable value, of the entire State of Wyoming.

Unfortunately, Wyoming, as is the case of many Rocky Mountain States, because of its location, its remoteness, its depth, its severe geological structures and so forth, is a very expensive place in which to do business. Some of the laws and regulations that have been discussed this morning have a direct monumental impact on our business and industry in that part of the country.

Insofar as the windfall profits tax is concerned, the industry in the West and the association feels that, without question, it should be immediately repealed. We see it as nothing more, at the present time, than a compliance burden that is needlessly draining funds, not only from the government but from the industry, that could be better utilized in other activities.

Should the price of oil increase the trigger mechanisms of the Act—and as we have heard this morning, we are getting very close to that on tier 1—our producers and explorers believe such action would represent a significant disincentive which would discourage not only reinvestment by the industry in the business but would discourage outside investment by those who are looking at the industry. If we maintain and continue a policy of that nature, we believe it would probably be more beneficial to OPEC and some of those who are sending us oil than to our own domestic gas and oil industry and the security of the United States.

With respect to tax incentives, they are not only appropriate, but we believe they are an absolute necessity. The heavily taxed capital intensive oil and gas industry, as you heard this morning, is in desperate need of some form of economic stimulation. I think it should be important to note that several States in the West have taken it upon themselves to enact, during the past legislative sessions, several incentives—production incentives, enhanced recovery incentives, maintenance of marginal production incentives—so as to try to encourage not only new exploration and production but maintain existing production and protect current reserves from premature abandonment.

We believe that the federal government should also look at such action as an effort of complementing the States' activities and their efforts, and increasing the stimuli available to the industry.

In talking to the folks in the West about what they would like to see and what they think would be most effective—you have heard them all this morning—the percentage depletion comes in as one that they feel should be reapplied to all production. Certainly the transfer rule should be repealed, as should the 50 percent net income limiter. And the intangible drilling cost definition should be expanded to include the geophysical and geological work, as should the definition be changed so as to include expensing in the year in which the actual expenses incurred.

Credits are desirable. We have a problem in the western public land States that may not be recognized in the others, and that is federal royalty. Perhaps credit should be investigated against royalty obligations for new exploration and production activities. Or, as was discussed in the previous panel, an across the board credit for exploration efforts.

In addition to that, we are suffering immensely from the uncertainty and the confusion generated by the fact that there are numerous rules pending before various regulatory agencies of this nation and before the Congress that have us up in the air as to how we are to value our production for royalties, if we are to include produced waters as hazardous waste, etc. Those are adding to the confusions and the frustrations of the industry as are the tax policies, and anything you could do would be most appreciated in that regard.

In summary, let me tell you that we appreciate the opportunity to be here. We are in support of your efforts and we really appreciate the hearings and the information that you have received today.

[The prepared written statement of Mr. Robitaille follows:]

PETROLEUM ASSOCIATION of WYOMING
951 Werner Court, Suite 100
Casper, Wyoming 82601

Comments of Richard T. Robitaille
before U.S. Senate Finance Subcommittee
on Energy and Agricultural Taxation
June 5, 1987

Mr. Chairman, members of the subcommittee, I am Richard T. Robitaille, Executive Director of the Petroleum Association of Wyoming, a division of the Rocky Mountain Oil and Gas Association. I appear before you on behalf of hundreds of companies and individuals active in all phases of the petroleum industry and responsible for more than 90% of Wyoming's petroleum exploration and production.

Wyoming is the sixth largest oil and gas producing state, the fifth largest in oil reserves and sixth in natural gas reserves. The state's petroleum industry has not escaped the unprecedented declines in seismic, drilling, production, well completion and leasing activities. Marginal wells have been shut in, enhanced recovery projects shelved, drilling prospects abandoned and reserves are falling. The state suffers from high unemployment, numerous bank and business failures, increased bankruptcies, declining retail sales and reduced funding for state and local governments as well as education.

The association supports the repeal of the Windfall Profits Tax Act. The Act currently represents nothing more than an administrative compliance burden for government and industry. It is needlessly consuming funds which would be better utilized by securing additional domestic resources.

Should oil prices recover to levels which would trigger provisions of the Act, a tremendous disincentive for increased domestic activity would be reinstated. The continued ill-advised siphoning of a portion of the improved revenues will reduce industry reinvestment funds and discourage outside participation. Failing to encourage energy development or defend our country from foreign influences, maintenance of such a policy will be more beneficial to OPEC than the United States.

Tax incentives and amendments to current laws are not only appropriate, they are an absolute necessity. The heavily taxed, capital intensive petroleum industry is in desperate need of economic stimulation. Effective tax incentives can and have been instituted without increased costs to the consumer. Several states, including Wyoming, have recently taken steps to encourage new exploration, maintain existing production and protect against premature abandonment of reserves through a combination of production tax reductions, enhanced recovery incentives and regulatory reforms. Similar action by the federal government will provide additional stimuli, complement state efforts and provide evidence that the U.S. is serious about an energy policy.

Specific changes which will provide tax incentives and assistance include:

- Reinstate the 27½% percentage depletion for all production of independents, small and large companies. Repeal the current 50% of net income per property limitation.
- Change intangible drilling cost (IDC) recapture regulations to allow for recapture in the year which expenses are actually incurred. Include within the IDC definition geophysical, geological and unrecoverable casing costs.
- Consider a credit, either temporary or permanent, against federal royalty obligations for new production.
- Offer tax credits for domestic expenditures for new energy development.
- Establish and maintain a definitive policy by which federal royalties are based on a wellhead or lease value determined by actual prices received, minus necessary transportation or enhancement expenses.

In summary, we generally support the efforts and concepts contained in S200 and S233.

Senator **Boren**. Thank you very much.

Just a couple of questions because we have gone overtime, and I don't want to hold the panel.

I wonder, Mr. Stafford, do you have any estimate of how much royalty income has fallen in the past 18 months to 2-year period of time?

Mr. **Stafford**. We had figures six months that were $3.8 billion, and they have been updated to $6 billion, and we are looking for an industry concensus on it right now. That is just about our estimate.

Senator **Boren**. $6 billion?

Mr. **Stafford**. A $6 billion loss from a base price of $25.00 per barrel. And that was where we calculated on the $25.00 not the high of $36.00 per barrel.

Senator **Boren**. So from $25.00 to where it has gone, there was a $6 billion loss to royalty owners?

Mr. **Stafford**. Yes. It is a weighted average that goes down to 11, which is the low backup, and to the mid-16s and then to our current price. But, like I said, with all the bank failures and closures and farm closures and everything, the multiplier effect, that has been just absolutely enormous.

Senator **Boren**. Devastating.

Let me ask Mr. DiBona and Mr. Robitaille if they might comment on the question that I asked the earlier panel in terms of the tax credit proposals, if you would favor broadly applying those credits with a smaller credit or if you would apply more very tightly target credits of a larger amount of credit. What would be your view on that?

Mr. **DiBona**. It is a question I have not addressed to our members, but my guess is that they would opt for the more broadly applied credit, a smaller number applied more broadly. And in part because as you look at the actual history of activity, and look at the discoveries, you will find that extensions of existing fields and other things incidentally that are affected by the windfall tax have discovered since 1979 the bulk of the additions to reserves, almost 90 percent of them.

Mr. **Robitaille**. I would agree with that in general, Mr. Chairman. If you want to be effective you need to apply broad-based credit; however, recognizing the nature of the industry and the percentage in development drilling as opposed to the percentage for exploration, the risks involved and so forth, I believe that you would get a significant response if you sweeten the pot by increasing the incensive or the credit to the higher risk development areas, to the high risk exploration areas, to the wildcats, but still maintain a broad credit for other exploration and production activities.

Senator **Boren**. So a broad credit with some additional target to be worked out within it.

Mr. **Robitaille**. Yes, sir.

Senator **Boren**. Dr. Cooper, What is your feeling in terms of what we would call an artificially low price that prevailed in the 10 to 18 dollar range that we experienced in 1986 and 1987? What kind of impact do you find from your research that that has had in terms of energy conservation? I just noticed, unscientifically, that I don't see many automobile ads that are emphasizing conservation. You see more that are now emphasizing performance.

What impact have the artificially low prices had on the conservation efforts and also the development of alternative energy sources which, of course, many of them are more expensive to produce and have been in the past linked to the price for oil and coal and other basic energy sources that are available?

Dr. COOPER. There are two responses. One, there is no doubt that the decline in prices changes the behavioral patterns of consumers. They are more likely to buy less efficient commodities and run them more often and, therefore, consume more energy.

But we feel, for instance, that it is exactly in the face of that market signal that fuel efficiency standards for automobiles, which we have back-slid on, should be strengthened. I mean that is the conservation response that we would like to see, exactly. In the face of the contrary market signals when the social concern of national energy security is greatest, that you need the strongest standards, and those are the kinds of policies we would like to see.

We have also seen, for instance, a decline in renewable development of alternatives. But, of course, we have given up the tax credits for many of those items as well, so that those alternatives are no longer being subsidized through the Tax Code, if you will.

Senator BOREN. So would you favor going back to tax credits for the development of the alternatives?

Dr. COOPER. No. We have seen those playing field levels significantly, and we supported the tax reform package that came through last year. What we would like to see is a renewed commitment to the strategic petroleum reserve which we see as the front line of defense in terms of national energy security, and renewed commitment to things like research and development, fuel efficiency standards, which we think are the least cost ways to build long-term security.

Senator BOREN. So at this time you would not really favor any particular incentives for development of alternative energy sources, even though the price has caused these to really take a nose dive in terms of what is getting developed?

Dr. COOPER. We supported the tax Act last year, which did away with most of those incentives, and we have not come back and asked for them. Obviously, earlier in the decade we supported those incentives. But if the playing field has been leveled—and we think it has—then we think we should live with that and move on the opposite direction of standards.

Senator BOREN. With all due respect, when you talk about the playing field being leveled, since development of new energy sources is usually relatively expensive, far more expensive than say development of oil, or whatever, that is already available in the marketplace, these more exotic sources, be they from shale, or be they from solar, or whatever we are happing to talk about, how are we going to find a way to develop those then, or is there an advocacy of the direct government to appropriation to develop those?

Dr. COOPER. Well we think there is a role of government in research and development and perhaps commercialization. But we believe that those alternatives should pass the market test as other sources of energy should.

Senator Boren. What about the dependence on foreign sources? I gather that you are not particularly concerned, and there is not particularly any problem—you were talking about the drain America policy—so there is really no objection on the part of your organization to us going to 60 percent or more dependence on foreign sources.

Dr. Cooper. No. Quite the contrary, there is a deep concern about that. But it is our understanding of the resource base, and the inevitability of dependence that you will build genuine long-term stability on the demand side by reducing consumption, and you build fundamental short-term stability by having the strategic petroleum reserve that is adequate to meet a very significant and a very long lasting interruption, which we have never had.

The point is that the world's resource base, the ability of the world to produce oil at a price, is clearly—potentially it is asking political manipulation at a fairly low price. The economic cost of finding and producing oil out there in the world are fairly low compared to the economic cost of producing and finding oil here. The key factor is political.

In the short-term, political instability either by administration within a cartel, a military accident, can produce a severe shock. But the fundamental response there is the strategic petroleum reserve. And we have testified before the Congress that we think it ought to be a billion and a half barrels, not 750 million, and it ought to be filled much more quickly.

In the long-term, the ultimate solution is not to produce your way out of dependence but to conserve your way out of it.

Senator Boren. Well I agree with you about SPRO, but, with all due respect, I am not sure that we can be that effective with restraining consumption. I think it is going to take a combination. And I am alarmed that some of our conservation efforts have slipped back. But I think it is going to take a combination of conservation and particularly not only maintaining the sources we have, but developing new sources.

Mr. DiBona, did you wish to comment on that?

Mr. DiBona. Yes. I just wanted to comment on that response if I might.

There were three points that occured to me. One of them is that to the extent you are interested in leveling the playing field and forgetting about the fact that there is a cartel out there that may play games with us, but just focusing on that point, then I don't see how you could not argue for eliminating the windfall profits tax, because it is a tax which is applied to a domestic oil and not to foreign oil. Also, it discourages U.S. production. It would help U.S. consumers. It would help to slow down the rise of any future price, foreign price rises, and, therefore, can only be beneficial to consumers in the United States.

Senator Boren. I can tell from body language that Dr. Cooper wishes to respond to that. At least he has moved over to his microphone. I will allow that response. And then let me say the chair, unfortunately, has to attend another meeting at 1:00, so I will have to not allow a full debate, although I think it would be very illuminating. Dr. Cooper?

Dr. COOPER. Well I dutifully avoided any comment on the windfall profits tax in both my written and oral statements.

Senator BOREN. The Chair took that as an encouraging sign. [Laughter.]

Dr. COOPER. And that was a negotiated position. I will say the following in defense of the windfall profits tax. It came at a time when we were coming out of regime of price controls, faced with huge price shock, and it was intended to do a specific thing: identify categories of oil, its stated prices with inflaters and a time period over which it proposed to capture economic rents.

As pieces of legislation go, I think it was a very reasonable and enlightened approach to identifying economic rents and trying to capture them. So enlightened was it that we are no longer capturing any rents when there are no rents to be captured. It has been stated today that we are not collecting it. And you are right. And why are you right? Because Congress gave you a piece of legislation that was careful to say, we want those rents. And it captured some rents and it did not capture nearly as much rents as we thought that it would capture.

It is perfectly legitimate for Congress to undertake such an enterprise. The uniqueness of the tax applied to this one industry which we have heard simply reflects the uniqueness of the fact that the magnitude of economic rents that we were looking at at that time are far beyond anything we typically encounter in our competitive economy, because a competitive economy erodes economic rents very quickly. So that in concept and design, when it was put in place it made sense, and it is no longer tapping any economic rents, and that only attests to the sensibility of the Act.

On a going forward basis, I have no great passions about the windfall profits tax.

Senator BOREN. I think that is a good note on which to close. [Laughter.]

And if the reporter wishes to underline the last sentence and put it in bold face——

Dr. COOPER. And my friends in the consumer movement will be angry at me for so testifying.

Senator BOREN. Well I think that there is always room to recognize change circumstance and we appreciate that.

Let me express my appreciation to our panelists and the others that have testified earlier. I think that these hearings have been very, very useful, very helpful. They form an important record upon the rest of our colleagues will be able to base decision because we are very hopeful that the Finance Committee will be reporting legislation, legislative proposals in this area, to the full Senate. And the hearing records of meetings like this one become an important basis for study by staffs and by members who do not serve on the Finance Committee, as well as those that do, to form judgments on proposals that will be before them. So this has been a very useful meeting. And I thank you for your participation.

[Whereupon, at 12:59 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

TO:

Subcommittee on Energy and Agricultural Taxation
Committee on Finance
United States Senate

FROM:

H. Richard Heede, Research Associate
Rocky Mountain Institute
1739 Snowmass Creek Road
Old Snowmass CO 81654-9199

RE: **Hearing on tax incentives to increase energy security (5 June 1987).**

BETTER WAYS TO REDUCE OIL IMPORTS

During the upcoming Subcommittee hearing there will be a clamor for renewed subsidies to the oil and gas industry. Certainly, rising oil imports hold the potential to harm national security, and the domestic petroleum industry is struggling due to the less favorable investment climate created by the Tax Reform Act of 1986 as well as by the OPEC-driven collapse of oil prices. The rationale of the proponents of resubsidization will be that our nation's security and well-being depend on providing tax incentives designed to stimulate exploration activity and increase domestic reserves and rate of extraction.

Tax incentives will have this effect, of course, but at what cost? Are there more cost-effective solutions? And, most fundamentally, *is it in the national interest to hasten, with tax incentives, the already advanced depletion of America's oil resources?*

This paper analyzes the problem of rising oil imports, outlines past and recurrent responses to similar energy crises, and reviews the Senate Subcommittee's proposed resubsidization of the domestic oil industry in the context of the goal of reducing oil imports. The paper proceeds to argue that far more cost-effective solutions for reducing oil imports are available to Congress and the American people -- namely more efficient use of oil. Finally, specific options are suggested for Congressional consideration.

Rising oil imports and the conventional U.S. responses

The original problem normally posed is that rising oil imports threaten our economic well-being and national security.

- U.S. oil imports are rising. Recent data show that the U.S. imported 32.8 percent of total oil and petroleum products supplied in 1986,[1] and many analysts agree that the fraction could plausibly increase further, perhaps even into the 50-70% range, by the early 1990s[2,3].

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[1] Net imports of crude oil and petroleum products increased 23% in 1986 to an average of 5.3 million barrels per day, out of an average of 16.1 million bbl/d supplied. This is a 1986 import fraction of 32.8% (up from 27.3% in 1985; 1973-1986 high: 46.5% in 1977). Energy Information Administration, Monthly Energy Review, January 1987.

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analysts agree that the fraction could plausibly increase further, perhaps even into the 50-70% range, by the early 1990s[2,3].

- Vulnerability leads to insecurity. Our Nation feels vulnerable with such a high import fraction, recalling the fear and turmoil surrounding the oil embargo of 1973-74 and the energy crisis of 1977-78. The conventional U.S. response is to project military power to ensure access to vital resources, in this case oil from the Middle East. Even though the U.S. buys only a small fraction -- 5.6% in 1986[4] -- of its oil from the Persian Gulf states, the United States spends an estimated $54 billion[5] annually on military forces in or assigned to the Persian Gulf area.[6] There are, of course, other strategic reasons for this significant U.S. military presence in the Gulf. While it is impossible to allocate a fraction of these expenditures realistically to ensuring oil supplies versus giving military comfort to our friends or discouraging "Soviet adventurism" in the region, it is clear that a major rationale for the U.S. projection of force is the fact that the Persian Gulf states possess 57% of the world's proven oil reserves.[7] It is thus clear but not quantifiable that the U.S. taxpayer is paying a high premium for oil which we can either import from elsewhere at $18/bbl or save at home for a fraction of $18/bbl. Simply dividing the now conservative $54 billion of annual expenditures on Gulf force projection by the 1986 average U.S.

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[2] See, for instance, Robert Hirsch, "Impending United States Energy Crisis," Science, 20 March 1987, pp. 1467-73.

[3] The net merchandise trade deficit for oil is down to $48 billion in 1985, compared to a high of $76 billion in 1981.

[4] The U.S. relies on Canada (4.9%), Mexico (4.3%), United Kingdom (2.2%), and Norway (all non-OPEC states), plus Nigeria (2.6%), Venezuela (4.8%), Indonesia (1.9%), and other non-Persian Gulf states (6.2%) for its oil supplies. Only 5.6% of the petroleum supplied to Americans in 1986 came from the Persian Gulf (which translates to 17% of our crude oil and product imports). Persian Gulf imports are rising, however, having increased from 1.9% of oil supplied in 1985, and 3.3% in 1984, but sharply down from 14% in 1977.

Thus, of total imports in 1986, 54% were non-OPEC, an additional 31% were OPEC but non-Gulf, and over 45% came from the Western Hemisphere -- 50% if Britain is also included. This suggests that the stability, prosperity, and friendliness of Mexico, Canada, and Venezuela may well be more important to U.S. interests in the 1990s than those many Persian Gulf states.

[5] Howard Morland of the Coalition for a New Foreign Policy, Washington, DC. His analysis is based on the FY85 Budget, and thus predates the recent buildup, especially after the attack on USS Stark. Earl Ravenal's (Georgetown University) comparable estimate is $47 billion.

[6] The Persian Gulf states supply a much greater fraction of the imports of European countries (30%), Japan (59%), and developing countries such as India and African states. This leaves open the question of why the United States is paying the full cost of protecting other friendly nations' oil supplies. Indeed, why is the United States flagging and escorting Kuwaiti tankers? Five reasons stand out: (1) a policy of containing the Soviet Union, (2) support for our friends in the region, (3) rising U.S. oil imports, (4) the U.S. economic interest ensuring that oil flows freely to our major trading partners, and (5) a wish to rely on U.S. military forces, not on those of our allies (German and Japanese naval forces, for instance, are strictly limited to home defense).

[7] The Persian Gulf states possess 397 billion barrels (56.7%) of the world's 700 billion bbl of proven recoverable reserves. The Soviet Union has 61 billion bbl (8.7%), Mexico 49 billion bbl (7.0%), the United States 28 billion bbl (4.0%), Venezuela 26 billion bbl (3.7%), and the rest of the world 140 billion bbl (20.0%). Energy Information Administration (1986), Annual Energy Review 1985, p. 227. One can understand the American sense of energy insecurity if we recall that U.S. consumption is running at nearly 6 billion barrels per year, of which domestic extraction accounts for roughly two-thirds. Consider also that domestic extraction is sure to shrink and that consumption will rise if unchecked by further efficiency improvements.

imports from the Gulf (897,000 bbl/d) would yield a military premium of $170 per barrel (1986$) -- 15 times the average price of Saudi crude in 1986.

- In addition to the military option described above, another conventional U.S. response is to encourage enormously costly large-scale energy-independence projects such as efforts to produce synfuels from coal and oil shale. Opening up the coastal plain of the Arctic National Wildlife Refuge to full oil and gas leasing, other extensive offshore oil and gas leasing, and similar Federal efforts to support capital-intensive energy projects in preference to more efficient use of energy suggest that the government is more responsive to special interests than to the broader national interest. Most of these heavily supported energy solutions -- all undertaken with genuine but narrow national interest in mind -- produce high-cost trickles of energy, frequently cause significant environmental degradation, and end up making us *more* dependent on imported energy since each dollar spent on supply cannot be spent on efficiency.

- Import dependence threatens our economic well-being: 1) a $48 billion oil import bill equalled 36% of the 1985 trade deficit[8]; 2) high import dependence opens the door to a supply interruption[9], which would likely cause a recession; 3) importing oil from abroad displaces domestic employment in the oil sector, shrinks the operations of petroleum companies, and reduces tax revenues; 4) capital investment in domestic exploration and new supply has decreased sharply (much of the capital instead going into mergers and acquisitions, i.e., old supply).

In sum, a high and increasing oil import fraction aggravates the trade deficit, exports American jobs[10], reduces Federal revenues, makes the country vulnerable to another supply interruption, triggers support for high-cost energy options, and -- due to our policy of projecting military power to assure access to oil -- embroils us in conflicts not in our national interests.

Failure of tax subsidy solutions

The Subcommittee is focusing on a timely and important topic: how to reduce U.S. oil import dependence. It should be incumbent on the Subcommittee, however, to look for the best ways *to reduce this dependence*, rather than limiting the scheduled hearing to ways of resubsidizing the oil industry. Taxpaying Americans will support Congress to stimulate the most cost-effective investments, not the most costly ones. The discussion below outlines the salient reasons why tax incentives to the oil industry would be one of the *least* efficient means of reducing imports. It also discusses what the best buys are, and how imports can be reduced at least cost to the American taxpayer/consumer.

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[8] The U.S. imported $345 billion of merchandise in 1985, and exported $213 billion, for a trade deficit of $132 billion. This is equivalent to about 28% of the 1985 national energy bill ($430 billion paid directly + -$50 billion in Federal subsidies).

[9] Curiously, the Reagan Administration has scaled back the acquisition of oil for the Strategic Petroleum Reserve at just the time when prices dropped from $25-$34 per barrel to $7-18/bbl. The 1986 SPR fill rate averaged 48,000 bbl/d, versus fill rates of 118,000 bbl/d in 1985 and 197,000 bbl/d in 1984.

[10] Clearly, jobs are being lost in the U.S. petroleum business. But resubsidizing the domestic oil industry is a costly and inefficient way to increase American employment.

- The United States is the most intensely explored and drilled petroleum province in the world. Generally, the larger and more accessible oil fields are discovered early in the exploration cycle, and consequently the resources remaining to be discovered are increasingly small, at greater depth, or in hostile and remote areas like the North Slope of Alaska and offshore.[11] Oil companies are in business to make money, not necessarily to find oil. And if escalating costs are making it unprofitable to find new oil, providing tax incentives for exploration is unlikely to stimulate much activity at the margin. Witness:

- The drilling boom of 1977-85 found 2 billion barrels of new recoverable oil in Alaska and the contiguous United States.[12] This discovery rate represents a mere *3.8%* of U.S. consumption, however, or 5.4% of domestic extraction for the same nine-year period. The petroleum industry spent well over one hundred billion dollars -- and received Federal subsidies on the order of forty billion dollars -- on this effort to boost reserves.

- For the market to work effectively, it must have a fair and equitable tax code that does not discriminate against market entry or against competitors. The Tax Reform Act of 1986 went a long way toward redressing the heavy subsidization of some energy forms -- particularly the oil and gas and electric utility industries -- relative to their energy competitors: energy efficiency and renewable energy technologies.

- In FY1984, subsidies to the oil industry totalled $8.6 billion (not including $4.6 billion to natural gas). For comparison, subsidies to efficient use of energy equalled $0.9 billion. Since the oil industry extracted more energy than did efficiency, a suggestive method of comparing the productivity of these Federal investments is to calculate the energy yield per dollar of subsidy.[13] Thus, subsidies to oil industry yielded 2.2 million BTU per dollar of subsidy, whereas energy efficiency -- by far the best buy -- produced energy savings of 17.9 million BTU per dollar of subsidy.[14]

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[11] The United States is increasingly becoming a high-cost oil supplier. For instance, in the heyday of oil exploration, wildcatters averaged a discovery rate of over one hundred barrels per foot of exploratory drilling. This discovery rate has sunk to around five bbl/ft. Better surveying techniques help somewhat, but the U.S. cannot escape diminishing returns in oil exploration. Some pertinent papers include: Hall and Cleveland (1981), "Petroleum drilling and production in the United States: yield per effort and net energy analysis," Science, 211, pp. 576-579; Grossling (1977), "The petroleum exploration challenge with respect to the developing nations," in R.F. Meyer (ed.) The future supply of nature-made petroleum and gas, pp. 57-70, Pergamon Press; M.K. Hubbert (1975), "Hubbert estimates from 1956 to 1974 of U.S. oil and gas," in Grenon (ed.), Methods and models for assessing energy resources, pp.370-395, Pergamon Press; Heede (1983), A world geography of recoverable carbon resources in the context of possible climatic change, National Center for Atmospheric Research, CT-72, Boulder, CO; and W.L. Fisher (1987), "Can the U.S. oil and gas resource base support sustained production?" Science, 236, 26 June 1987, pp. 1631-1636.

[12] In the period from 1977 to 1985, only 2 billion barrels of economically recoverable oil were found in new U.S. and Alaskan fields. L.F. Ivanhoe (1987), "Impending Energy Crisis?," letter to Science, 15 May 1987, p. 763. This nine-year rate of discovery is enough for 125 days of U.S. consumption (1986 consumption was 5.89 billion barrels), falling short of domestic extraction by 94.6 percent.

[13] Optimally, we wish to compare, for each energy form, a year's subsidy to the quantity of new energy produced in that year -- or saved, as in the case of efficiency. For example, the amount of new oil discovered per dollar of Federal subsidy to oil, or new energy saved per dollar of subsidy to efficiency (once a barrel of oil is burned, however, it is gone, whereas a more efficient car saves gasoline throughout its lifetime). We do not have adequate figures for productivity at the margin, and inasmuch as this method would be an excellent guideline for evaluating

- Since no one has analyzed energy subsidies since the Tax Reform Act was passed, it is unclear whether the Act made the energy market-place more or less equitable.[15] The Act did eliminate a number of tax subsidies, however, and it would be as inefficient to grant tax incentives to the oil industry now as it was prior to tax reform. Resubsidization of the worst energy buys is not only wasteful of the taxpayers' money, but far less effective at reducing oil imports, which is the Subcommittee's real goal. Investing instead in higher energy productivity yields far more savings -- both in dollars to the taxpayer and in displaced oil imports -- than spending the money on tax incentives for domestic oil exploration.

Least-cost solutions

If the objective is to displace oil imports -- which is the Subcommittee's stated policy goal -- then Congress should not thwart the principle of fair competition nor bypass the efficiency of the market system, but encourage the country to invest in the most cost-effective energy form, namely *saved* barrels of oil. The Department of Energy's 1985 National Energy Policy Plan states that energy conservation has "proven to be the most expeditious way to reduce the need for new or imported energy resources, and in fact it now contributes more to balancing our national energy ledger than does any single fuel source."[16] DOE's Energy Research Advisory Board agrees that conservation and more efficient end-use technologies can be "enormously important."

- Instead of drilling for expensive new oil fields, the country would be far better off tapping two little-known domestic supergiant "oilfields," each bigger than any in Saudi Arabia, and each capable of sustainably producing (not just temporarily extracting) over five million barrels of oil per day at costs of a few dollars per barrel. One of these -- the "weatherization oilfield" -- exists in relatively uninsulated sieve-like American buildings, and could be tapped through basic insulation, reglazing, and

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various Federal incentive options, we hope this will be a subject for future research. Lacking these figures, we compare each energy form's FY1984 subsidy to the total energy produced or saved in FY1984. See note below.

[14] Comparable figures for other energy forms: natural gas: 3.76 million BTU/$; coal: 5.06 million BTU/$; electric utilities: 0.29 million BTU/$ (0.63 million BTU/$ for fossil electric [including fuel subsidy] and 0.07 million BTU/$ for nuclear electric); hydroelectric: 0.78 million BTU/$; fusion energy and synthetic fuels: zero BTU/$; non-hydro renewables: 1.63 million BTU/$, and efficient use: 17.87 million BTU[illegible] of subsidy. Richard Heede (1985), "A Preliminary Assessment of Federal Energy Subsidies in FY1984", invited testimony to the House Subcommittee on Energy Conservation and Power, 20 June 1985, Rocky Mountain Institute, 28 pp. See also Heede and Lovins (1985), "Hiding the True Costs of Energy Sources", Wall Street Journal, 17 Sept. 1985, p. 28.

[15] The Congress should have available to it reviews of Federal subsidies to several economic sectors -- energy, agriculture, transportation, and mining, for instance -- on a regular basis, especially prior to debating significant new bills affecting these sectors. The General Accounting Office has been suggested as an appropriate author for these "current Federal subsidies" analyses. This writer's "Preliminary Assessment of Federal Energy Subsidies in FY1984" (available from Rocky Mountain Institute) and "The Hidden Costs of Energy" (with Richard Morgan and Scott Ridley, available from the Fund for Renewable Energy and the Environment, Washington, DC) are still the most up-to-date and comprehensive energy subsidy analyses available.

[16] Department of Energy (1984), 1985 National Energy Policy Plan, GPO, p. 5.

weatherstripping. For example, extensive use of advanced windows could save as much oil, and gas fungible for oil, as we get from Alaska (about one-fifth of U.S. demand). Using the equivalent of one year's budget of the Rapid Deployment Force (meant to secure our access to Mideast oilfields) to improve insulation in American buildings could *eliminate* Persian Gulf oil imports. As Amory Lovins points out, "improving buildings or cars could eliminate U.S. oil imports before new Arctic or offshore oil, synfuels, or power plants could come on line, and at a five to ten times lower cost."[17]

- The other supergiant is Detroit's "accelerated-scrappage-of-gas-guzzlers" oilfield, representing the savings available by getting gas-intensive automobiles off the road faster and replacing them with efficient cars. Re-establishing automobile efficiency standards from 26 mpg to 27.5 mpg -- which Chrysler achieved, but which the Administration revoked -- could save more oil, and do so faster and cheaper, than exploring and drilling for new domestic oil. Simply reestablishing the 27.5 mpg standard would save nearly five billion gallons of gasoline per year.[18] Fahrenwald and Herendeen have estimated that available technologies can cost-effectively *save one quarter* -- about 26 billion gallons -- of our annual gasoline consumption.[19] Either of these "oilfields" could *eliminate* U.S. oil imports before a synfuel plant, power plant, or Alaskan North Slope oil field could deliver any energy whatever, at a tiny fraction of its cost, and with none of its alarming vulnerabilities to disruption.[20]

Conclusion

The United States faces a potentially serious security risk in our rising imports of oil. The U.S. is becoming a high-cost oil supplier, and we, as a nation, have three distinct options: (1) subsidize the domestic oil industry -- thus passing part of the bill to our taxpayers, and not getting much import displacement in return for our investment; (2) stockpiling and supply diversification; and (3) support energy efficiency and alternative liquid fuels. The hearing before the Senate Finance's Subcommittee on Energy and Agricultural Taxation is restricting public comments to the first option.

Congress has the option to foster oil import displacement at the lowest cost per barrel to the Nation's taxpayers and consumers. Rather than resubsidizing the slow and capital-intensive domestic petroleum industry, Congress has more cost-effective options at its disposal: 1) remove all remaining subsidies to both energy supply and energy efficiency so that energy forms can compete on economic merit; 2) encourage efficiency through Federal research and development; and 3) strengthen manufacturing standards such as automobile and building efficiency standards.

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[17] Amory B. Lovins, letters to Science, 15 May 1987, p. 764, and to The Wall Street Journal, 1 May 1987, p. 21.

[18] About 5% of the annual consumption of motor gasoline in this country. Recalculated from data supplied by Arthur Rosenfeld, Lawrence Berkeley Laboratory, CA, personal communication.

[19] Their energy savings supply curve suggests that at a gasoline price of $1/gallon, we can save 3.5 Quads per year through the use of cost-effective and available technologies. Examples include improving the efficiency of accessories such as air conditioning and power steering, the automobile's aerodynamics and rolling resistance, and weight reduction. Data interpreted from P. Fahrenwald and R. Herendeen (1982), Energy efficiency supply curves for automobiles and light trucks, Energy Research Group, Document 325, University of Illinois, Urbana, IL.

[20] I am indebted to Amory Lovins for these ideas, expressed in his comments on the Department of Interior's Draft Arctic National Wildlife Refuge, Alaska, Coastal Plain Resource Assessment, which recommends opening to full oil and gas leasing the coastal plain of the Arctic National Wildlife Refuge. Mr. Lovins' letter is available through Rocky Mountain Institute. See also A.B. & L.H. Lovins (1981), Brittle Power: Energy Strategy for National Security, report to FEMA, Brick House, Andover, MA.

Incentives may be appropriate to help level the energy playing field if Congress is unwilling to desubsidize the entire energy sector. This author believes, however, that desubsidization -- not resubsidization -- provides the cheapest, fastest, most efficient and equitable solution. This option also has strong and favorable implications for U.S. competitiveness, balance of trade, budget deficit, employment, and environmental impact -- and, last but not least, has the potential to reduce oil imports faster and cheaper than resubsidizing the oil industry.

HEARING.........PROPOSALS TO REPEAL THE
WINDFALL PROFITS TAX AND TO INCREASE U.S. OIL RESERVES

THE SENATE FINANCE SUBCOMMITTEE ON
ENERGY AND AGRICULTURE TAXATION
SENATOR DAVID BOREN (D) OKLAHOMA CHAIRMAN

TESTIMONY TITLED SEND IN THE "A" TEAM (YOUR DOMESTIC DRILLERS FOR OIL AND GAS)

SENATOR BOREN AND YOUR COLLEAGUES, SENATORS MATSUNAGA, DASCHLE, WALLOP, AND ARMSTRONG AND SPECIAL INVITEE SENATOR NICKLES, I AM H. VAUGHAN WATKINS, JR., INDEPENDENT GEOLOGIST FROM JACKSON, MISSISSIPPI, AND VICE PRESIDENT OF NATURAL RESOURCES FOR THE SOCIETY OF INDEPENDENT PROFESSIONAL EARTH SCIENTISTS (SIPES). I AM ALSO CHAIRMAN OF THE NATIONAL ENERGY ADVISORY COMMITTEE FOR SIPES. I AM SUBMITTING THIS WRITTEN TESTIMONY FOR MYSELF AND AT THE REQUEST OF THE BOARD OF DIRECTORS OF SIPES, PHILIP J. McKENNA, PRESIDENT.

SIPES IS SOME 1400 MEMBERS STRONG, EACH MEMBER REPRESENTING AN INDEPENDENT ENERGY BUSINESS. WE ARE SURVIVORS OF A ONCE HEALTHY, INDEPENDENT SECTOR WHO COLLECTIVELY DRILL, IN NUMBERS OF EXPLORATORY TESTS, FOR NEW ENERGY RESERVES FOUR TIMES MORE OFTEN THAN DO MAJOR MULTI-NATIONAL OIL COMPANIES. DURING NORMAL TIMES A SIPES MEMBER HAS A KEY ROLE IN THE MAJORITY OF THE WELLS DRILLED IN THESE UNITED STATES. I AM SURE THAT EACH SENATOR ON THIS DISTINGUISHED PANEL REALIZES THAT THE ENERGY BUSINESS IS THE ONLY MAJOR DEFENSE INDUSTRY THAT DOES NOT COST THE AMERICAN TAXPAYER A SINGLE PENNY!

SIPES SHARES THE EXPRESSED CONCERN OF THE DISTINGUISHED SENATOR BENTSEN (D) TEXAS ON THE HEARING ISSUES OF TAXATION AND INCREASING THE U.S. OIL RESERVES.

A. FIRST LET US ADDRESS INCREASING U.S. OIL RESERVES AND THE ENERGY SECURITY AND BALANCE OF PAYMENTS BENEFITS TO OUR NATION THAT THIS WILL CAUSE.

PAGE TWO.

SEND IN THE "A" TEAM! INDEPENDENT OIL MEN (THE "A" TEAM) DRILL 90% OF THE WILDCAT WELLS IN THESE UNITED STATES AND FIND MORE OIL AND GAS RESERVES THAN DO THE MAJOR COMPANIES. IT STANDS TO REASON AND IT IS SO VERY SIMPLE TO LOOSEN THE BONDS AND LET THE INDEPENDENTS DRILL. SUPER-EFFICIENT INDEPENDENT DRILLERS INVEST THE MAJORITY OF THEIR FUNDS IN EXPLORING FOR NEW RESERVES, A MOST DESIRABLE TRAIT FOR OUR NATION.

INDEPENDENTS WILL BUSILY DRILL IF THERE IS:

1. A HIGHER PRODUCT PRICE (±24.00 POSTED)
2. A STABLE PRODUCT PRICE
3. A FAVORABLE WHITE HOUSE POLICY
4. A FAVORABLE CONGRESSIONAL POLICY
5. A PROGRESSIVE INSTEAD OF REGRESSIVE TAXING POLICY

LET US NOW STATE THAT THE UNITED STATES IS NOT RUNNING OUT OF HYDROCARBON RESERVES. EXCITING FRONTIER AREAS CAN BE EXPLORED IF THE PRICE IS ADEQUATE. FURTHER, THE CURRENT DEPLORABLE STATE OF THE DOMESTIC OIL INDUSTRY IS LARGELY DUE TO A LACK OF ADMINISTRATION OIL POLICY DESIGNED TO PROVIDE RELIEF FROM THE MID-EAST PRODUCERS PRICE MANIPULATIONS.....AND THE POTENTIAL FOR EVEN ANOTHER MIDDLE EAST BOYCOTT INCREASE.

SEND IN THE "A" TEAM AND THE U.S. OIL RESERVES WILL CERTAINLY BE INCREASED AND THE PRODUCTION DECLINE CURRENTLY BEING EXPERIENCED WILL BE DRASTICALLY REDUCED AND THE AMOUNT OF OIL BEING IMPORTED WILL CERTAINLY BE REDUCED. WHAT A UNIQUE HELP FOR OUR BALANCE OF PAYMENTS!

B. NOW LET US ADDRESS THE TAXATION ISSUE. THE SIPES BOARD OF DIRECTORS RECOMMENDS THE FOLLOWING:

1. REINSTATEMENT OF THE 27-1/2% DEPLETION ALLOWANCE
2. REMOVAL OF THE DEPLETION DELETION WHEN A PROPERTY IS TRANSFERRED
3. A 15% TAX INVESTMENT CREDIT ON OIL AND GAS WELL EXPENDITURES
4. EXCLUSION FROM APPLICATION OF THE ALTERNATE MINIMUM TAX TO I.D.C.'S
5. REMOVE THE "WINDFALL PROFITS" EXCISE TAX

ALL OF THE ABOVE TAX ISSUES IN CONCERT WOULD MOST PROBABLY INCREASE TAX REVENUES FROM THE INDEPENDENT OIL SECTOR BECAUSE OF THE INCREASED PRODUCTION AND INCOME IT WOULD PRODUCE. THIS ACTION IS A NECESSARY ALTERNATIVE TO THE INCREASED UNITED STATES MILITARY PRESENCE IN THE PERSIAN GULF, PARTICULARLY SINCE VERY NEARLY ALL OF THIS UNITED STATES NAVY-PROTECTED OIL IS DESTINED FOR OTHER COUNTRIES. UNITED STATES FUNDS EXPENDED IN THIS INCREASED PROTECTION EFFORT COULD BE FAR BETTER UTILIZED IN DEVELOPING SECURE RESOURCES WITHIN THE UNITED STATES.

DISTINGUISHED MEMBERS OF THE SENATE FINANCE SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION, THANK YOU FOR ALLOWING ME TO GIVE THIS TESTIMONY. *PLEASE TAKE OUR RECOMMENDATIONS UNDER FAVORABLE CONSIDERATION AND MAKE A SOLID COMMITMENT TO THE "A" TEAM.

*THE SIPES BOARD OF DIRECTORS CONCURS WITH THE STATEMENT PRESENTED BEFORE YOUR COMMITTEE ON JUNE 5, 1987 BY THE VERY ABLE RAYMOND H. HEFNER, JR., CHAIRMAN OF THE INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA. AFTER READING A TRANSCRIPT OF MR. HEFNER'S REMARKS, THE SIPES BOARD IS IN AGREEMENT WITH HIS ANALYSIS OF CURRENT INDUSTRY CONDITIONS AS WELL AS HIS RECOMMENDATIONS PRESENTED TO YOUR COMMITTEE TO STRENGTHEN THE OIL AND GAS INDUSTRY.

CHAMBER OF COMMERCE
OF THE
UNITED STATES OF AMERICA

ALBERT D. BOURLAND
VICE PRESIDENT
CONGRESSIONAL RELATIONS

1615 H STREET, N. W.
WASHINGTON, D. C. 20062
202/463-5600

June 10, 1987

The Honorable David Boren
Chairman
Subcommittee on Energy and
  Agricultural Taxation
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The U.S. Chamber of Commerce is pleased to have this opportunity to express its support for your bill, S. 255, to repeal the windfall profit tax (WPT) on oil, as the Subcommittee considers measures to increase energy security.

The Chamber is concerned about the current energy situation. More than 150,000 oil and related-industry jobs have been lost; operational oil rigs have declined by two-thirds since January 1986; and oil imports have risen to record levels. The WPT is a clear disincentive to investment in future domestic exploration and production; the Chamber believes that for this reason alone it should be repealed.

The WPT was enacted in 1980 to capture some of the profits that were expected to result from the decontrol of domestic oil prices. Described by President Carter as the "largest tax ever levied on any industry in the history of the world," it penalizes domestic production by imposing a tax on the petroleum industry of up to 70 cents of every dollar above governmentally set price levels.

In 1986, the world price of oil dropped below the trigger level for the WPT. Despite the fact that industry has paid no WPT for more than a year, costly compliance and administrative requirements stand.

While it is impossible to predict with any certainty the future of world oil prices, if prices rise, domestic production would be encouraged. However, under present law if prices return to pre-1986 levels, the WPT would be activated. Payment of the WPT would drain money from the petroleum industry, which otherwise could be invested in further exploration and development.

The WPT is an anachronism from the era of price controls. The nation has reaped the benefits of oil price decontrol. It is now time to repeal the WPT.

The Chamber requests that this letter be made a part of the hearing record on proposals to repeal the windfall profit tax and to increase U.S. oil reserves.

Sincerely,

Albert D. Bourland

cc: Members of Subcommittee on Energy and Agricultural Taxation
Janet Pollan, Majority Tax Counsel
Greg Jenner, Minority Tax Counsel